The Canadian Chartered Accountant

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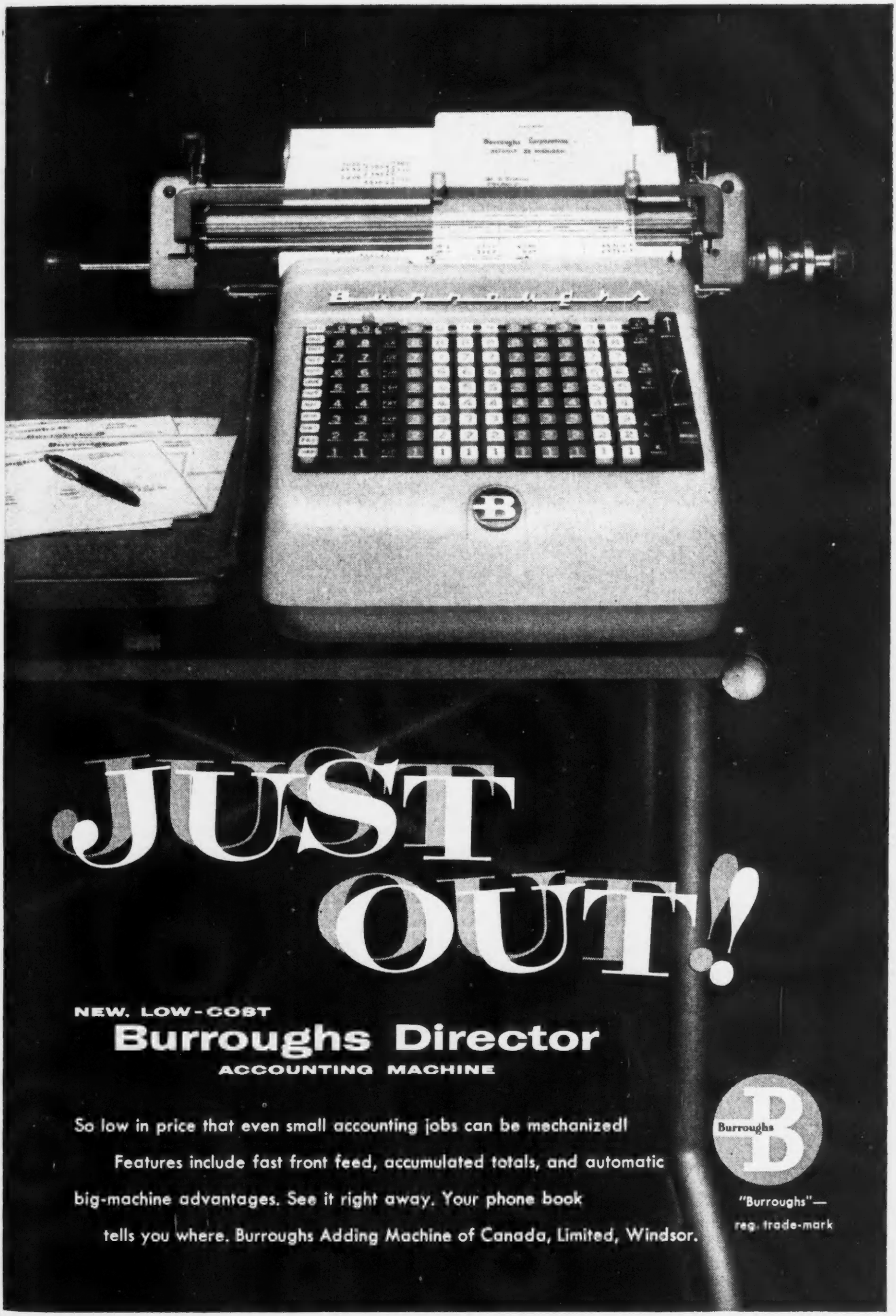
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In this Issue

STEFAN HANSEN, F.S.A.

In recent years the subject of pension plans has come more and more to the fore in our industrial life. On this account a general discussion by an authority on the subject seems timely. A pension plan has a marked effect on the current income of the employer as well as the employee, and Stefan Hansen discusses this and other problems in his article "Industrial Pension Plans".

The author is a Fellow of the Society of Actuaries and Director of Group Insurance of the Great West Life Assurance Company. He joined his present company in 1945, was chosen group secretary a year later, became group actuary in 1948 and in 1950 was appointed head of the company's group operations.

ROGER WELLINGTON, C.P.A.

Direct costing has received considerable attention in the last few years by industrial accountants. It raises numerous problems for the public accountant who may not be familiar with many of its techniques. The author of the article "Direct Costing and its Implications in Financial Reporting" is a public accountant who examines both sides of the question and comes up with some stimulating points of view on this important subject.

Roger Wellington is a partner in Scovell, Wellington & Company, New York, and has specialized in the development of better cost accounting and cost control. He received his Master of Business Administration Degree in 1939 from Harvard University. He is an active member of the American Institute of Accountants and other U.S. accounting bodies.

Sweetness and Light

THE objectivity of truth is perhaps its greatest jewel. A thing cannot both be and not be at one and the same time, says the philosopher. But isn't it strange how sometimes a thing can be the prime fact of existence to the person concerned and quite inconsequential to those who are unaffected?

Take, for instance, a toothache. Early last month I starred in a real throbber which bounced and pounded for a week before I finally reached the specialist who was to bring relief. By that time it had become the principal concern of my life beyond which all else paled into insignificance. When I arrived at the endodontist's office and a very efficient nurse with chart in hand said, "What is the history and nature of your trouble?" I regarded this as an invitation to tell ALL.

I began with how I had felt a slight twinge some 10 days previously but had done nothing about it because of a bad snowstorm at the time, how in 2 or 3 days later the tooth jumped when I drank my afternoon cup of tea, how next morning I had called up my own dentist and found to my dismay he could not take me until the middle of April, how the torture had increased so much during the course of that day that by afternoon I was forced to call back and beg to be taken earlier. Then I went on with how the dentist had taken pity and examined the tooth, pronouncing it dead and recommending root canal therapy by an endodontist. Then into the chapter of calling the office of the endodontist and learning that the first open appointment was April 19, and how next morning sitting in church it suddenly dawned on me that I was not paying one bit of attention to anything that was going on — all I could think of was my throbbing, pounding tooth. Finally how I had called again and arrangements were made to take me earlier and here I was, practically *in extremis*.

Through it all the nurse nodded sympathetically and I thought my tale of woe was very impressive. Later, however, I chanced to have a sneak peak at her chart and looked at the section "Subjective History of Complaint". All she had put was one measly little word:

Painful.

A few years ago a young C.A. appeared in court as a witness in a civil suit.

"Are you a chartered accountant?" queried the judge.

"Yes, your Honour."

"How good an accountant?"

The young man squirmed in his chair but declared, "Your Honour, I'm one of the best accountants in the city."

An older C.A. who happened to be in the courtroom was amazed because he had always thought the young man to be very shy and unassuming. When proceedings were adjourned he went up and asked him why he had made such a statement.

The lad blushed. "I hated to do it, sir," he explained, "but after all I was testifying under oath."

(Thanks to Morris Goodman, C.A. of Montreal for this story.)

JEAN VALE

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Letters to the Editor

Vernon, B.C., March 21, 1955

MORE ON THE AUDITOR'S REPORT

Sir: The article on auditor's reports appearing in the Accounting Research department of your March issue pertaining to auditor's reports has aroused an old point of interest with me.

I have acquired a growing belief that the auditor's report should contain a phrase to the effect that the statements have been prepared on a basis consistent with that of the preceding year.

In my opinion the shareholders should be advised of any material change in the method of determining the profit or loss for the year and they should not have to assume that there is uniformity in the accounting from year to year.

Your comment would be appreciated.

ALAN J. PARK, C.A.

The editor cordially invites discussion on articles appearing in *The Canadian Chartered Accountant*. We have given the author of the Accounting Research column an opportunity to reply to Mr. Park's letter.—Ed.

Sir: In the United States the standards of reporting on financial statements call for an expression as to whether the financial statements are presented in accordance with generally accepted principles of accounting and whether such principles have been consistently observed in the current period in relation to the preceding period.

The provisions of the Companies Act (Canada) do not state that such a disclosure must be made by the auditor in reporting upon the financial statements of Canadian companies. Reference to this problem was made by the Committee on Accounting and Auditing Research of the Canadian Institute of Chartered Accountants in two of their bulletins. Bulletin No. 1, A Statement of Standards of Disclosure in Annual Financial Statements of Manufacturing and Mercantile Companies, states:

> "If, during the fiscal period in respect of which accounts are submitted, there has been any important change in the company's accounting procedures which has had a material effect on the profits or losses as reported, the nature of the change and, if practicable, the effect on the results for the year should be disclosed."

The Supplement to Bulletin No. 6, The Auditor's Report, includes the following comments:

> "The form of the auditor's report recommended in Bulletin No. 6 and the form recommended in this supplement do not include reference to consistency in the application of accounting principles. However, Bulletin No. 1 (and section 87(1) of The Corporations Act, (Ontario)) requires disclosure of any important change in the company's accounting procedures which has had a material effect on the profits and losses as reported, the nature thereof and, if practicable, the effect of such change. Accordingly, in the absence of disclosure to the contrary, consistency in the application of accounting principles from year to year is implied."

For the most part Canadian auditors appear to have followed the suggestions expressed by the committee.

GERTRUDE MULCAHY, C.A.

Professional Cards

The Canadian Chartered Accountant

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NOTES AND COMMENTS

Program for Toronto Conference The technical program for the C.I.C.A. annual meeting has been completed and it promises to maintain the high standards set last year.

On the morning of Monday, September 12, J. Grant Glassco, president of the Canadian Institute, will open the technical proceedings with a review of the present status of the profession and its policies for the future. This will be followed by the viewpoint of a chartered accountant in industry. The morning session will continue with a government spokesman discussing accounting controls and auditing in government departments, and at the members' luncheon a guest speaker will talk on "Developments of Major Importance in Canada's Economic Growth".

Monday afternoon there will be three panel discussions. Two running concurrently in the early afternoon will deal with "Auditing Practices and Standards", and "Communication of Financial Information to Shareholders". Later, the remaining one will discuss "Current Accounting Practices", while a guest speaker will speak on "Development of Good Human Relations in Management".

Tuesday morning a guest speaker will discuss "Electronics Serving the Needs of Management", and two discussion groups, running concurrently, will study the requirements of the Ontario Securities Commission and "Taxation of Foreign Investment in Canada".

All the sessions on the third and final day of the conference will be held at the University of Toronto. Five separate discussion groups will meet concurrently throughout the first part of the morning and four more groups will meet later in the forenoon. Topics at these sessions will be of interest to chartered accountants both in practice and industry. The Wednesday afternoon panels will give members in public and administrative practice an opportunity to submit specific questions and a panel will sum up any interesting topics discussed throughout the conference. The annual general meeting for members will be held at 11:00 a.m. on Tuesday, September 13.

The Technical and Annual General Meeting Program Committee for this year's convention is under the chairmanship of Howard I. Ross. Serving with him are J. A. D. Craig, Wm. Hogben, Roland Chagnon, J. R. M. Wilson, E. H. Banks, C. L. King and F. S. Capon. In addition to the technical

program, plans are under way for a number of social activities. The registration centre will be set up at the Royal York Hotel all day Sunday, September 11. A luncheon for members will take place on Monday, September 12, and in the evening an opening reception will be held for members and their ladies. Special programs for the visitors are being arranged for Tuesday afternoon and evening and the conference will close Wednesday evening with the annual dinner and dance. The Committee on Arrangements comprises the following: J. A. D. Craig, J. D. McCormack, J. S. Whitehead, and F. H. Buck. A number of operating committees have also been appointed to attend to specific duties and social functions.

Retirement Benefits for the Professions The report of the Millard Tucker Committee on Retirement Pensions for the self-employed was published in England in February 1954. On March 2 of this year, the Chancellor of the Exchequer received a deputation from the Institute of Chartered Accountants in England & Wales, the General Council of the Bar and the Law Society. The deputation urged the importance of legislative steps being taken at the earliest opportunity to implement the recommendations made by the committee in regard to retirement benefits for the self-employed. The deputation appeared on behalf of some 20 professional bodies whose representatives had previously consulted together. Some of the problems involved were reviewed in an article "Capital for the Professions" which appeared in the March 19 issue of *The Economist.*

International Congress The Seventh International Congress on Accounting will take place in Amsterdam, Holland, from June 10 to June 14, 1957 inclusive. A Congress Committee composed of members of the Netherlands Institute of Accountants and the Association of University Trained Accountants has already been formed. Mr. A. L. de Bruyne, director of the Netherlands Institute of Accountants, has been appointed secretary. The address of the committee is: 491 Herengracht, Amsterdam and all correspondence concerning the congress should be sent to this address.

Fiscal Year End and the Budget Governments, like companies, have their annual reckoning. The Minister of Finance in his budget speech on April 5 announced a deficit of $194,000,000 for the 12 months ending March 31, 1954. After a run of 8 fat years of Budget surpluses, there has come a lean year and Mr. Harris pointed out that the deficit was due in part to the partial crop failure in Western Canada — a reduction in agricultural output great enough to equal 2% of the gross national product.

The Minister has forecast a budgetary deficit for this year of $160,000,000 but expressed the hope that the gross national product would so increase as to wipe out the deficit. Meanwhile, he proposed certain tax reductions which he considered "might be helpful in encouraging business activity and promoting employment". Corporation tax was reduced from 49% to 47% on income in excess of $20,000 and individual income tax was reduced by 12% to 13% for 85% of the taxpayers, grad-

ually dropping off until it reaches 2.8% at the highest income levels. The Minister also announced a proposal to form a committee to study the sales tax and hoped that a new bill will be ready next year on a revision of the Dominion Succession Duty Act.

At the conclusion of his speech the Minister announced the Government's intention to appoint a Royal Commission to survey economic prospects in Canada:

> "The sort of study we have in mind would include probable developments both in our productive capacities and in our external markets. It would include an examination of our population growth in both its regional and age distribution aspects.
>
> "I think the work of this royal commission will do several things. It will focus public attention, here and abroad, in a rather specific and detailed way, on our prospects. It will gather together the considerable amount of material already in existence, but scattered in many different places, that throws light on these problems. It will also promote and stimulate studies to fill the many gaps in essential factual material. It will sharpen our understanding of some of the problems we face, and will provide useful guides to governments and business, and to leaders in all walks of life, in making plans and policies for the future."

Accounting Terminology The committee on terminology of the American Institute of Accountants recently issued a bulletin intended to clarify the use of the words, "proceeds", "income", "profit", and "earnings" in connection with business operations and financial statements.

Finding present usage of the words in accounting, economic and legal literature "unfortunate and confusing", the committee recommended these distinctions:

> "Proceeds" should apply to receipts of all kinds, including borrowing, and should ordinarily be used only in discussing transactions, not as a caption in the principal financial statements.
>
> "Revenue" should be more widely used in referring to charges made to customers, clients, tenants and others for goods and services, rather than "income" or "gross income".
>
> In financial statements "profit" and "income" should be used only with the appropriate adjective "gross", "operating" or "net".
>
> "Income" is recommended instead of "profit" in the phrases "operating income", "net income", and "income statement" (instead of "statement of profit and loss").
>
> "Gross profit" may be used to describe operating revenue less cost of goods sold, but the committee prefers "gross profit on sales" or "gross margin" . "Profit" may also be used in describing a specific item, such as "profit on sale of fixed assets".
>
> The term "earnings" is used as a synonym for "net income", but the committee expresses the hope that one term will eventually be used. Recently there has been a trend toward "earnings", although a majority of published financial statements use "net income".

Tax Foundation Head Heading the Canadian Tax Foundation for the coming year will be J. A. Wilson, F.C.A., partner in the firm of George A. Touche

& Company. The Foundation has 1,150 individuals and about 700 Canadian companies represented in its membership and continues to gain stature as a source of authentic and informative data on our tax structure. It was originally formed under the sponsorship of the Canadian Bar Association and the Canadian Institute of Chartered Accountants.

Sir John Mann K.B.E., C.A. News of the death of Sir John Mann, K.B.E., M.A., C.A. at the age of 91 years appeared in the March 12 issue of *The Accountant*. Sir John was the son of one of the original members of the Institute of Accountants and Actuaries in Glasgow and was himself admitted to membership in 1885. He joined the staff of the Ministry of Munitions on the invitation of Mr. Lloyd George in 1915 and in 1917 became Assistant Financial Secretary of the Ministry and Controller of Munitions Contracts. Sir John received his K.B.E. in 1918.

Besides displaying a keen interest in the development of the profession, Sir John was particularly interested in housing problems and slum clearance. At one time he was secretary of the Workmen's Dwellings Company and he participated actively in the Public House Trust movement in Glasgow and the West of Scotland. He retired from active practice in 1941 but continued his interest in social welfare work to the end. He is survived by his widow, a daughter, and two sons who are both chartered accountants.

Last year Sir John wrote an article on the early days of the profession in Glasgow which was published in the Centenary Number of *The Accountant's Magazine*. He concluded with the following striking description of chartered accountancy which was featured at the C.I.C.A. annual meeting in Winnipeg:

> "Professional training for Chartered Accountancy is one of the finest disciplines. The word "Accountant" may be dull, it does not of itself quicken the imagination but "Chartered Accountant" is a world-wide passport.
>
> "To those who know what lies behind it, there is a life of variety and at times romance, a future of increasing scope, exciting to think about, and not least, the power of easing the burdens of tangled finance and fostering the health of the body commercial."

N.O.M.A. Conference The National Office Management Association is holding its 36th international conference at the Royal York Hotel, Toronto from May 22 to May 26, 1955. The exposition is a business equipment show with almost 100 exhibitors and the conference has as its theme "Controlling Office Costs".

C.A.'s in Tax Department At the present time 301 chartered accountants are employed by the Federal Government in the Taxation Division of the Department of National Revenue. Of this number, 25 are employed in the head office of the Department at Ottawa.

Direct Costing and its Implications in Financial Reporting

By ROGER WELLINGTON, C.P.A.

THE primary objective of the direct-costing plan is to provide the members of management regularly with information about the relationships in their business between costs, volume, and profits. To achieve this, manufacturing and other costs and expenses are carefully segregated between "direct costs" (those which vary directly with volume of production) and "period costs" (those which continue for an accounting period merely because the company is in business). Direct costs normally include direct material, direct labour, and items of expense that are directly related to production volume, such as some portions of electric power, process steam, supplies, and indirect labour. These costs are considered to be the costs of the products made. All other indirect costs of production and the fixed costs are considered to be the costs of being in business, having facilities available, and being ready to produce. As such, all these so-called fixed costs are considered to be incurred or accrue through passage of time, regardless of actual production volume, and are treated as costs of the period, not as costs of goods produced. In direct costing only the direct costs are charged to inventories and to cost of sales. All period costs are charged to profit and loss in the period in which they are incurred or accrued. In statements of operations, direct costs are deducted from sales revenue to show marginal income or "net contribution" toward period costs and profits.

As a result of this approach to cost, the management of a company using direct costing is furnished with periodic income and cost statements in which costs that vary with volume are distinguished from fixed costs. In making decisions on many questions faced in business operations, such information concerning marginal costs is essential. Direct costing provides this information directly from the regular accounts and eliminates the need to develop it by supplementary statistical compilations and analyses. It makes it easier to weigh the immediate effects of alternative courses of action, to choose realistic objectives, and to make decisions on a practical basis.

Uses of the Direct-Costing Plan

More specifically, costs developed in accordance with direct costing principles are useful to management in the following ways:

(1) The behaviour of costs and profits under various levels of business ac-

A paper read to the 66th annual meeting of the American Institute of Accountants, Chicago, 1953

tivity is developed and, therefore, the effect of changing volume on costs and profits is shown.

(2) Variable costs may be expressed clearly and controlled in terms of units of product or quantity of production, while fixed costs are expressed in terms of time. The confusion that arises from trying to combine both types in one set of unit costs is avoided.

(3) It is much easier to estimate the probable results in terms of cost and profit when the most advantageous course of action is chosen from a range of alternatives. The effect of resulting changes in volume on costs and income is an element in most managerial decisions, and managerial thinking often follows the marginal-cost approach.

(4) Cost data are readily available in an easily obtainable and understandable form, appropriate for budgeting and planning. The total amount of fixed cost that must be covered is clearly shown. The effect on profit of a specific change in sales volume can be calculated in a moment. Since direct costs are essentially cash costs, cash budgeting is simplified.

(5) Relative profitability, on a marginal-income basis, of different products or classes of sales is most useful, if not essential, for management to know in order to decide which products to make, which to promote, and at what selling prices or discounts.

(6) Once the sales figure is known, operating income can be estimated closely, without knowledge of the level of plant operations or the changes in inventory, which would affect operating income under conventional methods.

(7) Direct costing is practical and useful in cost control. It lends itself to use with a well-organized and integrated set of monthly internal operating and cost control reports. Fixed costs should often be considered to be period costs for purposes of short-range current operating decisions, and it is convenient to use statements developed on such a basis covering short periods, particularly for levels of management below the top. The costs that can be controlled by the lower levels of management, i.e. the direct costs, are segregated.

Can Conventional Cost-Accounting Methods be Useful in the Same Ways?

The areas of business management in which direct costing is most useful are important areas. Management needs the kind of information direct costing produces. Evidence of this is that the theory and practice of segregation of variable from fixed costs is not new, but was put into practice by some companies at least 40 years ago. Furthermore, the importance of separating direct costs from fixed costs, and the usefulness of the results for controlling operations at the various levels of management have long been advocated by professional cost accountants and management engineers experienced in the development and use of cost accounting.[1]

In the thinking and practice of these users and advocates, cost accounting should and did serve two purposes: it provides (1) information for the use of management in controlling operations, and (2) a proper basis for periodic fi-

[1] "Proper Distribution of the Expense Burden," A. Hamilton Church, 1908. "Cost Accounting and Burden Application," Clinton H. Scovell, 1916.

nancial statements. Cost accounting plans developed under this concept have served both purposes well. Basically, such plans are conventional in that all normal costs of production are charged to inventories and costs of sales, but at the same time internal cost statements that clearly differentiate between direct and fixed costs are prepared for operating control. The basic data are available to produce, in the form desired, the same useful information that is the product of direct costing. In addition, figures that provide a sound and generally accepted accounting basis for periodic inventory values and determination of profits are regularly developed.

Dangers and Weaknesses of Direct Costing

In spite of its usefulness as a tool for management, direct costing has its weaknesses and the direct cost approach can lead management toward some real dangers:

(1) For many of the needs of management and as a basis for many decisions, it is essential to have full product costs, including properly and individually allocated fixed costs usually based on normal volume. For example, decisions concerning long-range pricing policy, to be sound, must be based on such information. With direct costing in use, full costs must be developed in addition to the figures for the regular financial statements. As proof of this need, companies using direct costing all find it necessary to develop full product costs also.

(2) In segregating fixed costs, assumptions will have to be made as to a reasonable level of operations and as to some period of time, since "fixed" costs can be "unfixed" by management decision to a considerable extent with major changes in volume, and almost all costs except material costs have some fixed characteristics over a very short period. On the other hand, over a long enough span of time, all costs tend to become variable.

(3) Direct costing oversimplifies the complex relationships between sales income and costs. Many items of cost are incurred in relationship to individual transactions or per day operated and such costs only relate to sales on an average basis. For example, transactions might average to a certain dollar value apiece or to a certain number of units apiece and at the same time production might average so many units per operating day. As a result, changes in the average size of sales orders or production orders could have a marked effect on the relationship between volume and costs. Items of cost such as set up are incurred for changes in production and have the characteristics of fixed costs in relation to each production run rather than in relation to time.

(4) The use for operating decisions of statements prepared on a direct-costing basis implicitly assumes that plant and machine capacity and other overhead facilities or personnel are available to implement any decision reached on the basis of the "marginal contribution". In other words, the effect of additional or permanently reduced capacities and of the costs thereof has to be considered and developed before decisions can be reached. The conventional method of costing gives a clearer picture of what the results might be if major changes in capacity are contemplated than does a direct-cost income statement.

(5) The usefulness of direct costing is primarily in application internally to short periods and for purposes of current operating decisions. Its application and usefulness for long-range thinking, planning, and decisions is much more limited.

(6) Most successful companies have found, in the long run, that an exclusively or primarily marginal cost and income approach to their problems is not safe or healthy. There is great danger that the need to recover fixed costs actually incurred will be disregarded, and, with direct costing for internal reporting, top management will have to be constantly on the alert to protect against this danger. The danger is greatest in the smaller company where direct costing is used, particularly in the thinking of its sales department, since many such companies would not make the additional effort to develop carefully product costs that are complete.

The Purported Disadvantages of Conventional Cost-Accounting Methods

Many indictments of conventional cost-accounting methods have been made in writings of the proponents of direct costing, who believe that the conventional approach to costing is deficient in the following respects:

(1) Fixed and variable production costs are merged in charges to the same expense accounts and inventory accounts, and therefore the accounts give no clear picture of the relationships between volume and costs. Hence, management does not have, from its financial statements without supplementary analysis, a sound basis for decisions that will affect volume of production. The usual "gross profit" figures do not show marginal or out-of-pocket costs.

(2) Conventional methods and presentations are not clearly understood by management, and confusion results from trying to compare the operating results of one period with another. Management does not understand"over-absorbed burden" nor "under-absorbed burden", nor the effect of carrying forward in inventory values a portion of fixed charges. The proponents of direct costing believe that most members of management consider profits to be realized in relation to sales only, without reference to production activity.

(3) The "normal" volume of production on which burden rates may be based is at best an estimate that depends upon assumptions. The rates at which fixed costs are charged to product costs are affected by the volume chosen and therefore product costs themselves are affected.

(4) The values applied to inventories of work in process and finished goods include a proportion of fixed charges. Increases or decreases in these inventories cause a greater or lesser proportion of the fixed charges to be treated as assets and deferred to subsequent periods. Therefore, when the level of production is different from the level of sales, profits are not proportionate to sales but are also affected by the level of production.

(5) With the conventional methods and fluctuating volume of business (where production volume and sales volume are varying from period to period but not varying similarly at the same time), periods of higher sales may show lower profits and vice versa. Such

results are due to differences in the rate of absorption of fixed charges in product costs. The proponents of direct costing believe that such results are not logical and that management does not think them realistic. Conventional methods are not well adapted, therefore, for measuring results of operations over short periods of time, as an approach to computing unit product costs, nor for providing cost information for current operating decisions.

Five Criticisms

These criticisms of conventional costing methods can be reduced to five important points:

(1) Conventional methods do not segregate fixed from variable costs and therefore do not show the relationship between costs and volume or what will be the effect of changes in volume.

(2) Management does not understand the conventional "absorption" costing methods nor the customary presentation of operating results or unit product costs.

(3) Product costs that include fixed charges must, of necessity, be based partially on estimates or assumptions, at least as to useful life of fixed assets and frequently as to a "normal" rate of productive activity.

(4) Fixed charges are period costs — not costs of products made.

(5) Fixed charges should be absorbed, in the sense of being realized, only as sales are made and in no part through production activity. Therefore, there is no justification for including fixed charges in inventory values.

It is all too easy to "prove" that the results of conventional methods are poor by citing the unsatisfactory results commonly seen. Studies of such cases will show, however, that the unsatisfactory results are due to incomplete application of sound methods, compromises made to save clerical work, and generally incomplete factual information on which the figures can be based. Such weaknesses are not inherent in the conventional theory nor methods themselves; they are weaknesses in particular sets of figures or in particular organizations and their managements. The proper comparison to make is between direct costing, properly and thoroughly applied, and conventional cost accounting, properly and thoroughly applied.

I am reminded of the results that are often seen when a company is surveyed by one of the office-equipment manufacturers' sales engineers to determine potential savings through use of their mechanical equipment. Comparison is shown between methods as they are and revised methods using the mechanical equipment. When such a comparison is carefully analyzed, and the present methods are studied and reorganized to get maximum efficiency, as would also be necessary in order to use the mechanical equipment, a large portion of the prospective savings has often already been accomplished without the mechanical equipment. Similarly, the installation of direct costing requires that much be known about the behaviour of costs. This knowledge is most useful, but can be available under any good cost-accounting system.

With this approach in mind, let us consider these five points and their bearing on the pros and cons of direct v. conventional costing.

POINT 1. Conventional costing methods do not *require* segregation of fixed from

variable costs, as does direct costing. Many managements and accounting systems make only such segregations as are customary or are found convenient. However, most alert managements with well-designed conventional accounting systems have made and do make complete segregation of detailed items of cost and expenses into fixed and variable categories and maintain records thereof, so that statements showing direct or marginal costs are prepared and are used. This primary objective of direct costing can be and is achieved under conventional methods, although the regular financial statements are not prepared on a direct-cost basis. Statements showing direct costs are prepared for internal use separately from the financial statements. While managements should know their direct costs, "direct costing" is not required in order to accomplish this. Therefore, this is not a valid criticism of conventional costing methods as such, but rather a criticism (and a sound one) that many companies do not make such a segregation or do not make use of the results.

POINT 2. Lack of management understanding is a most serious deficiency, if true and if inherent in conventional costing methods. No matter what the method of development, financial operating statements cannot be used intelligently by management as a basis for judgment and decisions without full understanding of what the figures mean and on what principles and assumptions they are based.

Let us define what we mean by "management". If we mean all members of an organization above the position of supervisor, the criticism is undoubtedly valid as to a large proportion of management. If we mean only the top-management people who normally use financial statements as a basis for judgment and long-range decisions, any such blanket criticism of conventional methods is not justified. Lack of understanding at this level would lead to the conclusion that management is at fault rather than the methods. Naturally, if top management becomes "sold" on direct costing and enthusiastic about it, all levels of management are going to be thoroughly indoctrinated, but the same amount of enthusiasm would probably engender a like amount of indoctrination in other methods.

Direct costing is simpler and easier to explain to a production man or a salesman with little or no knowledge of accounting than is the concept of normal burden rates. A financial operating statement shows the sales figure and the period of time covered. No other data are needed to understand what the apparent relationships are: direct costs of products sold were at a certain ratio to sales; so many dollars of fixed costs were incurred for the period.

The "horrible" examples the proponents of direct costing like to cite of the poor cost accountant who is saddled with a conventional costing system and trying to explain to an executive why profits are down when sales are up could be countered with equally "horrible" potential examples under direct costing of trying to explain why the company is losing money when producing at capacity to fill firm sales orders for later shipment.

Perhaps the key to lack of management understanding of cost accounting lies in the mental processes or approach of many executives or managers who use

reports or figures for control. When presented with an operating statement, they have pre-conceived ideas, based on experience, knowledge of the situation, and some rough mental calculations, of what the results should be. If the statement results do not approximate their mental answers something must be wrong. If on further inspection no serious error in their own mental calculations is found, then the statement results are suspect. If the executive's approach does not parallel that of the cost accounting but he still considers his to be basically correct, no amount of explaining is going to satisfy him that the statements produced by the cost accounting system are right. Too many nonaccounting executives do not realize that different presentations of costs are necessary for different purposes.

It appears to be true that many members of management do not understand well enough the cost accounting used in their companies, and that it is easier to grasp the apparently simple relationships shown by direct costing than the more complex relationships of conventional costing. The complex relationships are really there, however, and ignoring them by the direct costing approach will not result in a better informed management.

POINT 3. Writers advocating direct costing have made much of the uncertainty in conventional costing resulting from the use of estimates and assumptions. Such criticisms are not pertinent because cost accounting by any method includes estimates and assumptions, necessitated by the nature of the situations dealt with and often by lack of available facts. Furthermore, direct costing involves its own set of assumptions and estimates as to which costs will vary directly with production and within what period the "fixed" costs will remain fixed. Also there is a basic assumption that costs are related only to production volume or to time. Depreciation, normally assumed to accrue with the passage of time, may actually in some part be incurred because of the wear and tear of productive activity. Direct labour, normally treated as a direct cost, in actual practice often tends to be related to time over short periods.

POINT 4. We may all accept as a fact that fixed charges are not, in general, affected by reasonable changes in current volume of production or are not dependent thereon. Can we accept the further conclusion that, therefore, fixed charges are not part of costs of products made? Such a concept seems to be completely at variance with:

(1) Common sense. Consider what would happen when a completely manual operation in the manufacture of a series of products becomes completely mechanized. Is it reasonable that the cost of these products then ceases to include any cost for this operation? Or consider the completely automatic "factory of the future". Will products from such plants cost no more than the material used? Or think of the situation where a company has the option to make or buy a product or a component. The "cost" and the inventory value will differ much more under direct costing than with conventional costing.

(2) Concepts of the public and of governmental bodies as to what cost is or what it includes.

(3) Usual business practice and generally accepted accounting principles, as

stated in Accounting Research Bulletin Number 43, Chapter 4:

> A major objective of accounting for inventories is the proper determination of income through the process of matching appropriate costs against revenues.
>
> As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location.

(4) Any requirement for valuation for outside purposes, such as insurance or sale of the business.

Of course, fixed charges are incurred or accrued with the passage of time, and they do represent costs of being in business and having facilities available for production. They are also, and at the same time, costs of production when the business or facilities are put to productive use. It is this dual nature that causes our difficulties, and costs based on the assumption that this dual nature does not exist are incomplete.

The approach of not charging fixed costs to product costs is a step away from the process of matching revenues against the costs that were incurred to produce the revenues. This is an accepted basic concept of accounting for periodic income. While it is customary practice not to match selling administratives expenses against the revenues resulting from these expenditures, this is done not because of any lack of acceptance of the theory, but because it is believed impractical to ascertain the relationship between these expenses and the revenues from any particular sale or period and hence to attempt a process of matching, or to develop reasonable justification for deferring part of these costs to future periods.

POINT 5. For many companies it does not seem reasonable to consider that all the fixed charges incurred each period should be charged or absorbed only against the sales made during that period. For companies that do not produce for stock but only to order, direct costing would produce most illogical results: loss of fixed overhead during the period of production and a corresponding increase in profit in the period of sale. Companies that produce fairly steadily but have peak selling seasons would show widely varying monthly profits during the course of a normal business year. The level of production does affect profits, and most businessmen consider that it affects unit costs in the long run. This being so, it seems more logical and more in keeping with the economic facts to recognize this effect in the income statement than to exclude it.

Direct Costing for External Financial Reporting

The external financial statements being considered are the balance sheet and income statement in the form presented in audited reports and in company statements accompanied by an opinion by independent public accountants.

In the balance sheet, the change resulting from the use of direct costing would be to reduce the valuation of inventory of work in process and finished goods. The comment has been made that, because inventory stated in this way would be shown at a value equivalent to an approximate cash cost to replace, this fact would be useful to readers of the balance sheet. Whatever benefit the reader might gain would not be available if LIFO is used for costs of materials. The reduction in net current assets from carrying inventories at direct cost might cause difficulties to arise under terms of any existing loan or preferred stock in-

dentures, or the change in method itself might violate the terms of such agreements.

The principal changes occur in the income statement. From net sales will be deducted the direct manufacturing cost of goods sold and also items that are "direct" selling costs, such as commissions or royalties. The resulting figure is intended to represent the net "contribution" towards period costs and profits ("merchandising margin" or marginal income). Then the period costs, including the fixed manufacturing costs, will be listed, and deducted in total. The net result is "net operating income". The amount of net operating income would differ from that in conventional statements to the extent that the amount of items classified as "fixed costs", which would be included in inventory values under conventional methods, differs as between the beginning and ending inventories.

Some Difficulties

In connection with the preparation and use of external financial statements on a direct-costing basis, certain difficulties and problems have been encountered or can be foreseen:

(1) The direct-costing plan produces financial statements in which inventories are not stated at cost, but at a value below cost. Such statements do not in many circumstances give a fair measure of periodic income and are not in accordance with sound and generally accepted principles of accounting.

(2) Financial statements on the direct-costing basis can mislead the reader seriously because of their apparent simplicity, and they tend to lack all-purpose usefulness. The kind of data from direct costing that are most useful internally are seldom presented in external financial reports. For example, statements of marginal income by products are considered by many to be the most useful statements produced by direct costing, and yet these are seldom given to outsiders.

(3) Many companies would object to disclosing to competitors, in external financial statements, their ratio of direct costs to sales.

(4) In practice, segregation of "period" from "direct" costs is difficult and involves the use of assumptions and estimates. The practicability of measuring and relating costs to activities and products in a particular set of circumstances will influence markedly the basis on which direct costs are actually segregated. If one company is willing, or is accustomed, to record certain facts relative to products and another company is not, the former will show items as "direct" costs which the second shows as "period" costs. Such lack of comparability in costs would not be as marked with conventional methods.

(5) If financial statements were changed to a direct-costing basis, it would be most important to make a clear disclosure of the fact of change of method. Otherwise misleading comparisons might be made, both with the past and with competitive companies. The amount of applicable "period costs" which had been excluded from inventories should be disclosed in each statement.

(6) Change-over from conventional to direct costing raises problems: (*a*) If external financial statements are continued on the former basis, methods

of adjusting inventory values from direct cost to that basis must be developed and applied. (*b*) Some method must be found to handle or dispose of that portion of the inventory value at the date of change-over by which the former cost basis exceeds the direct cost basis. (*c*) The change to a variable cost basis from "full" costs for inventory valuation probably will not be acceptable to taxing authorities.

Disposing of the "Period" Cost Component

The committee on research of the National Association of Cost Accountants, from their interviews with companies that had changed to use of direct costing, found that these companies had met the problem of disposing of the "period" cost component of their inventory at the date of change-over in various ways, for example:

(1) Fixed items of cost were dropped from product cost a few at a time over a period of years.

(2) The fixed-cost component, where substantial in relation to profit, was amortized over a period of years.

(3) Because previous methods of inventory valuation were somewhat arbitrary and below total cost, the general reclassification of cost accounts made at that time produced no substantial net change in inventory value.

(4) Annual inventory and profit figures are adjusted each year to the conventional cost basis by adding or subtracting an amount representing the net change during the year in the fixed or "period cost" component of inventory value. In Research Series Number 23, *Direct Costing,* the Committee on Research of the NACA cites various examples of how companies in practice make such annual adjustments of their direct cost figures.

There are a number of possible and reasonable ways of adjusting year-end direct-cost inventory values to the conventional basis, which includes a fair proportion of fixed manufacturing costs. The problem is one of determining what portion of the year's fixed manufacturing overhead is properly allocable to the quantity of work in process and finished goods on hand as at the balance-sheet date.

Where a company customarily develops "full" product costs in addition to direct costs, valuation of the inventories to include a fair proportion of fixed charges presents no difficulties. If no full product costs have been developed (which is an unsound and dangerous position), calculations will have to be made on the basis of reasonable assumptions. In some cases it may be logical to adjust the inventories as a whole, but such treatment would not recognize what may be marked differences in the proportion of fixed charges properly allocable to individual product groups or portions of the inventory. At least one company considers that the fixed-cost component of inventory remains constant in amount until there are permanent changes in production capacity or in the nature of the business. Such treatment is merely an expedient, and will not properly reflect periodic income.

Effects of the Switch on Financial Statements

All too many observers of financial statements look only at the net-income figure. While the probable differences

in that figure resulting from the use of direct costing may affect the opinions of such casual observers, what concerns us more is the effect on careful students of the financial statements such as creditors, bankers, financial analysts, and investors. Change to direct costs for financial reporting will affect these groups in the following ways:

(1) During a transition stage, when some companies were using direct costs and other comparable companies were not, there would be a good deal of confusion. There are more than enough differences of this sort between companies to worry about now, such as use of LIFO, accelerated depreciation, or no depreciation on fully depreciated facilities still in use.

(2) Comparisons over periods of time and between companies would be more complicated and difficult to make. Considerable education and publicity would be needed before there was a general understanding of the implications of direct costing.

(3) The facts disclosed by the direct-cost income statement could be of assistance in the analysis and understanding of an individual company, its internal characteristics and as a help in judging the probable immediate and near term effect on its profits from future changes or courses of action. For this kind of external use, the direct-cost approach could be helpful as information supplementary to the conventional income statement.

Effect on the Independent Public Accountant

We shall consider briefly how the use of direct costing in external financial statements will affect the independent public accountant. He will have to satisfy himself that the direct-costing presentation presents fairly the net income and results of operations for the period, that it seems to be suitable for the business, and that it does not tend to produce unreasonable or misleading results.

He must form an opinion on the propriety of the segregation as between "direct" and "period" costs. This segregation is basically important in a direct-cost income statement, but he will find it difficult to justify an opinion thereon. Changes in the way the business is operated, management decisions, contractual agreements, and increased mechanization, all may affect the behavior of costs and the determination of which costs are fixed and for what periods, and which costs are variable. There is not, at present, any set of accepted principles by which independent accountants can be guided in forming an opinion concerning the reasonableness of the assumptions or decisions made as to which costs are "direct" and which "period". Without extensive additional work, the independent accountant will have to rely in this matter largely upon the opinions and representations of the client's management. Although he now takes responsibility that the cost of goods sold is fairly stated, and we know that there is a great variety of apparently acceptable practices as to what items of cost are to be included in cost of sales, the independent accountant must assume additional responsibility by indicating that in his opinion the direct costs have been fairly segregated from the period costs. This additional responsibility relative to segregation of costs cannot be taken lightly because the direct-costing income statement is a "forward-looking" presentation in the sense that it is intended to show what will be the future

effect on profits of changes in volume. It implies, and the reader will infer, that the ratio of direct costs to sales and the amount of period costs will remain about the same in the near future and that the reader can expect that predictions he might make as to the future based on these relationships will hold true.

Using direct costing, the management of a client will be afforded a better opportunity than under "full" costing, while operating steadily, to shift profits between one fiscal period and the next by delaying or accelerating shipments and thereby decreasing or increasing the sales of a period. The resulting shift of "contribution margin" will exceed a similarly caused shift of gross profit. It is difficult for the independent accountant to cope with such manipulation.

Conclusion

Most of the articles and promotional literature on direct costing treat the problems of cost reporting, as reflected in financial statements, from the point of view of the management and the organization within the company. From this approach, and for internal reporting, direct-costing methods and principles and the related procedures have certain advantages in appropriate circumstances. However, most of these values can be obtained for management from proper application and use of conventional cost methods.

It appears that direct costing is aimed in general at overcoming weaknesses of conventional cost accounting in connection with internal presentation of unit product costs and in showing to management the results of short periods of operation. External financial reporting of manufacturing companies is not concerned with unit product costs or frequently with detailed statement of periods of less than one year. Because of this distinction, direct costing would not achieve in external financial reports what it is aimed at accomplishing internally. Direct costing does not appear to have any clear advantages in furthering the basic purposes of external financial statements nor will profits be measured as well as by conventional methods.

As independent public accountants, we are concerned not merely with the management point of view or the effect on only one company or even on only one industry. We are concerned with whether direct costing should be added to the body of generally accepted accounting principles in presentation of financial reports to the public. We should be fully aware of the direct-costing method, its advantages and limitations, and be prepared to consider with our clients its adoption for their internal accounting and reporting if we believe, based on full knowledge of each client's situation, its management, and its problems, that direct costing will prove more useful in operating the business.

The management of each company should have the benefit of internal statements that analyze costs and expenses between those that are variable and those that are fixed. Each will have to consider whether it prefers to use direct costing for regular internal accounting and financial reporting, with full costing as supplementary, or whether its cost accounting and reporting will be on the conventional basis with marginal costing supplementary. The conventional basis, properly developed and adequately reported, seems definitely superior for general use.

Accounting for the British Columbia Logging Industry

(Part II)

By Hugh H. Adair, C.A.

PART II — SPECIAL ACCOUNTING FEATURES

SPECIAL features of logging accounts are discussed briefly under the following headings:

1. Quantities
2. Deletion — stumpage
3. Road costs
4. Depreciation and amortization
5. Inventory valuation
6. Operating statements
7. Taxation.

1. Quantities

In logging accounting it is important to maintain adequate records of quantities of logs as many of the accounting entries are based on production quantities, and operating statements normally show average unit costs.

Cruise figures are the basis for setting depletion rates. Woods reports of logs felled and bucked determine the remuneration of fallers and buckers when paid by piece-work, and assist in estimating inventories of logs in the woods. The most important and reliable quantity records, however, are the official government scale bills of completed booms or rafts. These government scaling and royalty documents (S. & R. accounts) show the area from which the logs were cut (as determined from the official log mark affixed by means of a marking hammer in the woods), the log marks, species, grades, number of pieces, quantity, rate and amount of royalty, and amount of scaling fees and expenses. It is from records based on these scale bills that the log production quantity is determined, thus:—

	Unit *Bd. or Cu. ft.*
Sales quantity as per government scale bills	—
Add closing inventory of logs in booms as per government scale bills for logs boomed and scaled, plus loose logs and boomed but unscaled logs as estimated by company scalers	—
	—
Deduct opening inventory of logs	—
Production	—

All booms put up should be accounted for and charges for royalty, stumpage, towing, etc. collated with the quantity records.

Production determined as above should be compared with production as indicated by woods scale figures. There is always a lesser quantity of logs delivered to the booming ground than is shown by the

woods scale adjusted for culls and inventories of logs in the woods, but no set percentage of shrinkage can be given.

The percentage of shrinkage should be reviewed with management as to its reasonableness in the circumstances of terrain, operating policy, etc., and any considerable and unaccountable variations should be investigated.

2. Depletion — Stumpage

By depletion is meant the reduction of the quantity of timber in an area by cutting. For accounting purposes its cost is determined by dividing the book cost of the timber in an area by the estimated quantity (to calculate the cost per unit) and multiplying this unit cost by the number of units extracted. Depletion is recorded in the accounts at the end of each accounting period on the quantity of logs delivered to the booming ground during the period, i.e. the "production" of the logging operation for the period. The inventories of logs felled and bucked or cold decked in the woods do not, therefore, include a depletion charge.

Practice as to what constitutes a "timber limit" (a term used in the capital cost allowance regulations under the Income Tax Act but not defined) "tract" or an "area" is by no means uniform. For example, it may be all the timber comprised in a single purchase, all the timber in a watershed, or all the timber in designated districts.

Usually no attempt is made to account for depletion by species, nothwithstanding that some species are more valuable than others, a fact which has a bearing on the cost of the standing timber.

After commencement of cutting operations on a timber limit it is not common practice to capitalize carrying charges such as taxes, licence fees, forest protection costs, etc. Consequently the unit depletion figure established when cutting commences continues unchanged unless it is found that a change is necessary due to a re-cruise or revision of the estimate of timber in the limit. In the event of such a revision a new depletion rate is determined by dividing the residual book value of the timber at the commencement of the period in which the revision is made by the revised quantity. Retroactive adjustments of the accounts of prior periods are unusual.

The term "stumpage" is frequently used in the timber trade as a synonym for depletion, but it is also used with particular reference to original purchase cost. In cases where timber is not purchased outright but bought as cut, the term is used to refer to the payments made to the vendor (e.g. on government timber sales). Such payments should not be confused with royalties which may be payable to the Crown in addition to stumpage.

The question of value of land surface rights does not arise except in cases of Crown granted lands and land purchased for campsites, etc. Generally, little or no value has been attached to timbered land surface rights as the amounts involved ordinarily have been immaterial in relation to the value of the timber. However, with the current emphasis on sustained-yield forestry, logging accounting practice in this and other respects perhaps will undergo some changes.

Despite the fact that timber values generally have increased substantially over the years the timber has been held, the cost basis for depletion is still the generally accepted accounting practice. It is necessary, therefore, to view the results

shown by logging and lumbering accounts critically to judge the extent to which profits are derived from long-term gains as a result of increase in timber values rather than from normal operating profits based on present-day replacement values.

3. Road Costs

One of the problems in logging accounting is the selection of a suitable basis for amortization of expenditures on construction of logging truck roads or railroads. These expenditures are usually made well in advance of removal of the timber made accessible by construction of the roads, and the costs of construction may vary considerably on account of the relative difficulty of terrain, bridge construction, and other factors. The following methods, or a combination of them, will be found in use:—

1. Expenditure absorbed in operations as incurred. This practice is appropriate in a small operation or in cases where the extent of road construction ahead is not significant. In larger operations it is not uncommon to deal in this way with expenditure on roads branching off main roads.

2. Expenditure charged to operations in ratio of production for period to total timber made available by roads constructed. Interim write-offs during a year would be adjusted at the year-end to a rate per M. feet of production calculated somewhat as follows:—

Balance brought forward in road account at beginning of year		$ —
Construction costs incurred during year		—
	(A)	$ —

Standing timber accessible to roads constructed at end of year		— M. feet
Logs hauled (production) during year		—
	(B)	— M. feet

Amortization rate per M. feet: (A) ÷ (B)

In cases where substantial road construction is required before the timbered area is reached, the cost of such roads cannot reasonably be amortized according to this plan, but should be separately dealt with and amortized over the whole of the timber to be hauled over them.

3. The whole eventual cost of all possibly required roads for the purpose of removing all the timber from any specified area is estimated and amortization rate calculated by dividing such estimate by the total quantity of timber in the area. On account of the difficulties of estimating construction costs caused by physical factors, price changes, and revision of plans, this method is not generally favoured.

4. More or less arbitrary percentage of cost. The relatively recent adoption of this method in some cases is probably due to the introduction of forest management licences and the trend to sustained-yield forestry. Under the capital cost allowance regulations of the Income Tax Act a taxpayer may elect to include logging roads in Class 10 and claim a maximum 30% on the reducing balance provided the taxpayer has not included in another class (e.g. Class 15) other property acquired for the purpose of cutting and removing merchantable timber from a timber limit and which will be of no further use to the taxpayer after all merchantable timber has been removed from the limit.

4. Depreciation and Amortization

Expenditures on equipment and logging facilities are written off to operations by the usual percentage of cost

methods, or, where appropriate, by amortization based on the quantity of timber removed during the accounting period. The latter procedure is appropriate in respect of facilities such as camp buildings, log dump, and booming grounds which will be of no further use when all the timber has been removed. If, however, the service life of such facilities will be shorter than the duration of the logging operation, they should, of course, be written over the shorter period.

Reference has been made above to the methods adopted in connection with expenditures on logging roads.

5. Inventory Valuation

The generally accepted practice of valuing inventories at the lower of cost or market is followed.

Logs in the woods felled and bucked and logs cold-decked usually are valued at the progressive average cost of these operations. It is general practice not to recognize charges for stumpage, depletion or royalty in the accounts until the logs are in the booming ground, consequently inventories of logs in the woods normally do not include these costs. Because of this practice, some accountants prefer to classify costs carried forward for falling and bucking ahead as prepaid expenses rather than inventories.

Logs in the water are commonly valued at the lower of the average cost of all species and grades or the net realizable value. Ordinarily no attempt is made to differentiate in costs between the various species and grades, as apart from possible identifiable differences in stumpage costs, it is not practicable to make meaningful allocations of logging costs which are common to all production. In logging accounting it is standard practice to include practically all overhead and general expenses, other than marketing expenses, in costs of production. There are some possible exceptions such as interest, timber fees and expenses (particularly if in respect of idle limits), and bond discount and expenses.

Provincial Government royalty, if related to production quantities, is set up in the accounts at the same point as is stumpage and included as an element of cost of logs in water. To avoid the necessity of estimating royalties on logs in water not officially scaled, royalty is sometimes related to sales quantities and set up through the sales journal. In these cases royalty is shown on the profit and loss statement as a deduction from sales rather than a cost of production and is not included as an element of cost for inventory purposes. This practice, like that concerning stumpage on logs in woods referred to above, is justified by convenience and usage rather than by sound accounting theory.

6. Operating Statements

While many varieties of detail will be found in practice, the outline on p. 293 of the form of a typical operating statement for a logging concern which sells its logs on the open market will be found in general use in British Columbia.

In the schedule of woods or direct costs, expenditures are grouped according to the following main divisions of the physical operations:

- Falling and bucking
- Yarding and loading
- Hauling
- Booming

The extent to which costs are broken

OPERATING STATEMENT

	Quantity (*M.B.M.* *or cubic ft.*)	Amount	Average per unit of quantity (*$ per M.B.M. or per cu. ft.*)
Sales	—	—	—
Less sales deductions such as towing, insurance, and selling expenses	—	—	—
Net sales proceeds	—	—	—
Cost of logs sold:			
Production costs:			
Woods costs or direct costs— supported by schedule (1)	—	—	—
Overhead or indirect costs — supported by schedule (2)	—	—	—
Stumpage and royalty	—	—	—
Depreciation	—	—	—
	—	—	—
Add opening inventory	—	—	—
	—	—	—
Deduct closing inventory	—	—	—
Cost of logs **sold**	—	—	—
Profit on logs sold	—	—	—
Other charges and credits	—	—	—
Profit before income taxes	—	—	—
Estimated income taxes	—	—	—
Profit	—	—	—

down under the above general headings is dictated by the requirements of management. A typical classification is submitted in Schedule 1 (see pages 296 to 297) by way of example. It will be noted that apart from amortization of logging roads no allocation of depreciation charges is made, nor is any attempt made to apportion overhead or indirect costs.

Overhead or indirect costs usually fall into two general divisions: (1) camp overhead and (2) general expenses. Some of the items commonly found under these categories are listed in Schedule 2 on page 298.

Many of the larger concerns maintain supplementary analyses of costs and operating statistics that provide, for example, the following information:—

Costs (labour, materials and supplies) by machines — e.g. individual donkey engines, trucks, shovels, etc.

Production per man-day

Wire rope usage statistics

Truck operating statistics, such as mileage, cost per M. mile, tire mileage.

Cookhouse operating statistics — e.g. number of meals served, cost per meal by main elements of cost.

If operations are conducted at two or more locations, a separate set of operating statements would be prepared for each location.

In any comparison of logging costs it should be realized that differences in unit costs between different operations are due to two groups of factors. On the one hand are the factors of topography, density of stand, size of timber, distance from tidewater, etc. These are the things which a logging operator would take into account in deciding if the logging of a given tract was or was not a good "show". On the other hand, there is the efficiency or otherwise of the various parts of the logging operation.

The profit and loss statement illustrated above reflects the operations of a logging concern which sells its logs on the market. If logging operations are integrated with those of sawmilling or other processing, the statements would show inter-divisional transfers of logs in place of sales, and the "sales deduction" items of towing and insurance would be reflected in costs. Some concerns transfer logs to the processing divisions at market prices to develop significant operating results in each division. When this practice is followed it is necessary, of course, to eliminate inter-division profits from inventories.

7. Taxation
(as of December, 1954)

The question of whether a profit realized on the sale of standing timber is taxable has been the subject of a number of tax cases and the present position is by no means clear. The following cases are worthy of study in this connection:—

Anderson Logging Co. Ltd. v. *The King* (1925) S.C.R. 45

Cabus Creek Logging Co. Ltd. v. *M.N.R.*, 3 Tax A.B.C. 305

Sutton Lumber and Trading Co. Ltd. v. *M.N.R.* (1953) 2 S.C.R. 77

C. W. Logging Co. Ltd. v. *M.N.R.* (ITAB) Tax Rev. [1954] 2, 308, June 8, 1954.

Where timber is sold on a stumpage basis as cut the proceeds of sale presumably are includible in income by virtue of s. 6(y) of the Income Tax Act.

Despite the indication that it was the intention of Parliament that depletion allowances in respect of timber limits be allowed by regulation under s. 11(1)(b) of the Income Tax Act, such allowances have been provided for under s. 11(1)(a) and, as a consequence, it is understood that they are regarded by the income tax authorities as subject to the "recapture" provisions of the Act.

The pertinent sections of the Regulations regarding depletion are ITReg. 1100(1)(e) and Sch. C. The rate per cord or per board foot cut in the taxation year is determined by dividing the capital cost of the "limit" (an undefined term), less any residual value of the property, by the total quantity of timber as shown by a bona fide cruise. The rate may be re-determined by filing with the Minister before the commencement of a taxation year evidence that the quantity of timber in the limit was in fact substantially different from the quantity employed in determining the rate for the previous year. No retroactive adjustment is made; the new rate is calculated by dividing admitted "undepreciated capital

cost" by the estimated remaining quantity of timber at the commencement of the taxation year to which the new rate will apply.

The following excerpts from the Income Tax Regulations relate specifically to depreciation of logging facilities and equipment:—

Schedule B — Class 10 (30 per cent):

(1) property that was acquired for the purpose of cutting and removing merchantable timber from a timber limit and will be of no further use to the taxpayer after all merchantable timber has been removed from the limit, ***unless the taxpayer has elected to include another property of this kind in another class***

(m) mechanical equipment acquired for logging operations, but not including a property described in class 7

(n) access roads and trails for the protection of standing timber against fire, insects and disease

Schedule "B" — Class 15 (rate per cord or board foot based on quantity of timber — Schedule "D")

Property that would otherwise be included in another class of this Schedule but for the fact that

(a) it was acquired for the purpose of cutting and removing merchantable timber from a timber limit, and

(b) it will be of no further use to the taxpayer after all merchantable timber has been removed from the limit,

except property that the taxpayer has, in the taxation year or a previous taxation year, elected not to include in this class.

It will be seen from the above excerpts that property of the kind described in class 10(1) and in class 15 (examples of which are logging roads, camp buildings, and other facilities) besides qualifying for inclusion in various other classes, may, at the taxpayer's option, be included in class 10 or class 15. However, if a taxpayer elects to include in another class property which qualifies for class 15 he cannot later transfer it to class 15. Also, if a taxpayer wishes to include in class 10 property described in paragraph (1) thereof, he must include *all* of the property which so qualifies.

It is understood that expenditure on camps, roads, etc. which will have a useful life not in excess of, say, two to three years may be charged to operations as incurred.

The income tax authorities have outlined informally to the industry departmental interpretations and current assessing practices in connection with forest management licence are considered capcounting and taxation problems pertaining to these expenditures remain to be worked out. It is understood that expenditures made in acquiring a forest management licence are considered capital costs of the timber limits and so subject to amortization in accordance with ITReg. 1100(1)(e) and Sch. C to the regulations. This would include general survey and cruising costs, and professional fees paid to foresters, solicitors, and accountants. Ordinary recurring expenditures in connection with a regular productive forest management area operated on a sustained yield basis are normally regarded as current costs of the year in which they are incurred; such costs would include the cost of protecting standing timber from fire, insects, and disease; carrying charges such as land taxes; and the costs of reforestation. The costs of capital assets used in forest management operations may be claimed as capital cost allowances in accordance with the tax regulations. For example,

access roads, automobiles, and trucks would qualify under class 10 (30%), fire protection equipment and scientific equipment under class 8 (20%), and frame buildings under class 6 (10%). This classification does not refer to assets used directly in logging operations, most of which would qualify in class 10.

Schedule 1

DIRECT COST OF LOGS IN BOOMS

	Quantity	Amount	Average per unit of quantity
FALLING AND BUCKING:			
Labour	—	$ —	—
Tools and supplies	—	—	—
Opening inventory of felled and bucked logs	—	—	—
Total available	—	—	—
Distributed as follows:			
Cold-decked	—	—	—
Yarded and loaded direct	—	—	—
Closing inventory of felled and bucked logs	—	—	—
Total distributed	—	—	—
COLD-DECKING:			
Falling and bucking cost of logs piled (as above)	—	—	—
Cold-decking cost:			
Labour		—	—
Fuel		—	—
Wire rope		—	—
Repairs and supplies		—	—
	—	—	—
Opening inventory of cold-decked logs	—	—	—
Total available	—	—	—
Distributed as follows:			
Yarded and loaded from cold-decked piles	—	—	—
Closing inventory of cold-decked logs	—	—	—
Total distributed	—	—	—
FALLING AND BUCKING AND COLD-DECKING:			
Cost of logs yarded and loaded:			
Felled and bucked only	—	—	—
Felled and bucked and cold-decked	—	—	—
	—	—	—

Schedule 1 (Cont'd)

DIRECT COST OF LOGS IN BOOMS

	Quantity	Amount	Average per unit of quantity
YARDING AND LOADING:			
Labour		—	—
Fuel		—	—
Wire rope		—	—
Tools and supplies		—	—
Repairs:			
Labour		—	—
Parts and supplies		—	—
Moving, rigging and preparing settings		—	—
	—	—	—
TRANSPORTATION TO BOOMING GROUNDS:			
Labour of truck operators		—	—
Fuel and lubricants		—	—
Tire repairs:			
Labour		—	—
Parts and supplies		—	—
Maintenance of logging roads:			
Labour		—	—
Materials and expenses		—	—
Branch roads construction:			
Labour		—	—
Materials and expenses		—	—
Amortization of main logging roads		—	—
		—	—
BOOMING:			
Labour		—	—
Tools and supplies		—	—
Boom chains and boomsticks expense		—	—
Log dump and booming ground repairs:			
Labour		—	—
Materials and expenses		—	—
		—	—
Direct cost of logs in booms	—	—	—

Schedule 2

INDIRECT LOGGING COSTS

	Labour	Other	Total	Average per unit of quantity
CAMP OVERHEAD:				
Supervision				
Camp office expense				
Camp buildings repairs and maintenance				
Property taxes and rentals				
Timber fees				
Engineering and cruising				
Insurance				
Fire protection and fire fighting				
Workmen's Compensation Board assessments (if not distributed with labour charges)				
Unemployment insurance				
First aid				
Hauling crews and supplies				
Cookhouse and lodgings operating loss				
Commissary operating (usually credit)				
Vacations-with-pay (if not distributed)				
General camp expenses				
Subtotal of camp overhead	—	—	—	—
HEAD OFFICE AND GENERAL OVERHEAD:				
Executive and office salaries				
Office expense				
Telephone and telegraph				
Travelling expense				
Legal and audit fees				
Medical, hospital, and group life insurance				
Pensions				
Association dues				
General expenses				
Subtotal of head office and general overhead	—	—	—	—
Total indirect costs	—	—	—	—

(This is the concluding portion of a two-part article on "Accounting for the British Columbia Logging Industry". Part I appeared in the April issue of *The Canadian Chartered Accountant.*)

Industrial Pension Plans

By STEFAN HANSEN, F.S.A.

I WHY ANY PENSION PLAN?

Social Philosophy

EMPLOYER expenditures on pensions used to be justified on grounds of social philosophy. The theory was that a good employer should reward long and faithful service by providing at least the minimum needs of an employee who is no longer able to work. "He gave the best years of his life in my service — the least I can do is see to it that he is not destitute in the days that remain to him!"

Today this theory hardly squares with the everyday facts of our industrial life. To begin with, it is not the employee of long and faithful service who is likely to be in the greatest need. It is more likely the employee who is buffeted from one employer to another with intermittent unemployment who will most need aid when he can no longer work at all. Then again, long service will be more characteristic of well-paid key employees and executives — men with an opportunity to build a financial reserve — than of wage earners whose needs are the greatest. Finally, employees no longer give their life in service. Today they sell their service at a price over which they have at least as much control as the employer.

But even so, sentiment still plays a role in employer-employee relations, especially on the day of parting.

Tax Advantages

The employer gets no tax advantage from the establishment of a pension plan. He gets no better tax treatment if he spends 5% of his payroll on pensions than if he pays it out in higher wages. However, the employees get a tax advantage. Were an employee to get his 5% as an increase in wages, he would generally have to share it with the income tax collector and thus he might actually get only 4% or 3% out of 5%. Then too, if the employee saved his 4% or 3% he would not be able to keep all the interest earned on it. The tax collector takes a share of the interest unless the money is put into a pension plan. Consider an example:

> 5% of a yearly salary of $5,000 from age 30 to 65 with 4% interest tax free accumulates to $19,149.
>
> But the 4% "take home" from a 5% wage increase even if wholly saved would, after tax on the interest, accumulate to only about $12,500.

Actually in practice the "take home" from a 5% wage increase cannot be consistently invested; much less can the small amounts of interest thereon be reinvested.

From an address to the Manitoba Institute, October, 1954

So while the pension plan's 5% accumulates to $19,149, the savings accumulation from a 5% wage increase would theoretically be $12,500, or perhaps only $10,000 if the difficulty of small investments is allowed for. In practice it would likely be nearer $0 because the wage increase would, in fact, not be saved.

Investment in Efficiency

An employer who spends 5% of his payroll on pensions should get back the 5% "plus" through lower costs of production. The real motivation behind the phenomenal growth in pensions in recent years is the discovery that the employer who adds a pension cost to his expenses will effect an overall reduction in his cost of production. The reasons for this seemingly paradoxical effect are:

1. REDUCED LABOUR TURNOVER

Two trained employees can do as much as three untrained employees. If each of the trained get $300 per month, the two cost $600 per month. Suppose the untrained get as little as $225 per month each. The three of them cost $675, an increase of 12% in labour costs.

The illustrative figures used will vary but not the principle behind them. Labour turnover costs money. To the extent that an expenditure on pensions reduces labour turnover (and it does), it is an investment to effect lower costs of production just like the purchase of a new and better machine.

2. MORALE

One man who works well is worth five who work half-heartedly, for fear and a feeling of insecurity drain the spirit out of an employee. What the average man *was going* to save this year against his approaching old age, compared with what he *did* save is undoubtedly one of life's most persistent disappointments. In time disappointment gives way to worry, then to fear, even to panic. These ugly intruders take a heavy toll of any employee's productivity. If 5% invested in pensions returns 10% in greater productivity, it becomes an eminently sound investment in efficiency.

3. PROGRESS

Planned systematic retirement is sometimes the only *practical* means of passing responsibility to younger men with new ideas. These new ideas the long-employed and perhaps tired executive may not wish to try. If there is no pension plan for such older men, some settlement on severance may be arranged, but at best the negotiation is difficult and embarrassing. Often it seems quite impossible — and will not be tried, so the situation "drags". The younger men become discouraged and leave or they become so resigned to frustration that when their turn to step up does come they have lost their spirit of enterprise.

4. NET RESULT

Consider a possible example:
Employer of 1,000 employees produces 300,000 units per year.

(1) Suppose there is no pension plan. Average pay per annum is $3,000 or total payroll of $3,000,000. Payroll cost per unit is $10.

(2) After well-designed pension plan has been in effect long enough to produce results, labour turnover is reduced so that average length of service has increased. Longer average service means fewer untrained

and inexperienced employees, so that 1,000 better trained and more experienced employees now produce 350,000 units. Longer average service also results in higher annual pay, say \$3,100 instead of \$3,000.

Payroll cost	
1,000 at \$3,100	\$3,100,000
Pension plan 5%	155,000
Total	\$3,255,000

Cost per unit is \$3,255,000 divided by 350,000 equals \$9.30 per unit.

When there was no pension plan, the unit cost was \$10. After the adoption of a pension plan the unit cost of production dropped to \$9.30. If some firms in a given industry adopt good pension plans, those who do not may expect to find their costs of production non-competitive.

II BASIC PROVISIONS

Eligibility

The employee is invariably required to fulfil certain conditions to become eligible to join a pension plan. Most commonly he must attain a minimum period of service, say two years, as a permanent employee. Temporary and part-time employees are usually not eligible.

Eligibility may also depend on his employment status. The plan may be for only salaried employees. On the other hand it may be that only hourly paid employees are eligible, the plan being part of a union agreement. In this latter case there frequently will be a separate plan for salaried employees.

Sometimes a minimum age is a condition of eligibility. It might be age 21, or 25 for males and 30 for females. A minimum age requirement is usually undesirable, and a minimum age which is higher for females than for males is even more undesirable. The vast majority of female employees have no desire to remain in service until retirement — or even long enough to benefit from the usual vesting provisions of the plan. But experience teaches that they do want to be in the plan while employed. Their contributions constitute a welcome plan of forced saving with a tax advantage which makes their return, even without any interest, a good investment. The anticipation of this return on the universally-hoped-for day of marriage creates amongst female employees a satisfaction that is just as real and beneficial to the employer as the anticipation of old age security amongst male employees. A stable, experienced, and well-trained female stenographic and clerical staff is not only more productive in itself, but furthermore it increases the efficiency of the rest of the staff and usually makes for better customer relations, fewer errors, greater promptness, etc.

Retirement Benefits

RETIREMENT DATE

Most plans specify a fixed retirement date such as 65, or 65 for males and 60 for females. When the plan first starts it is common to let older employees retire at some higher age. For example em[illegible]loyees who, when the plan starts, are 5[illegible] or older retire 10 years later — 57 retires at 67; 64 retires at 74, etc. A variation of this would be that those 56 and over retire in 10 years but not later

than age 70. The date of attainment of the age so fixed is called the normal retirement date and retirement on that date is usually compulsory.

The employee may retire earlier, commonly at any time within the 10 years preceding his normal retirement date. However, the amount of pension he gets by retiring on this earlier date is such as can be purchased by the amount at his credit in the fund at the date of retirement. In this case early retirement occasions no additional cost to the plan.

It will usually be provided that retirement may be deferred with consent of the employee. As the present value of an *early* pension is equated to the present value of the accrued normal pension, it may be provided in the case of *late* retirement that the late pension is adjusted so that it is equal in value to the normal pension forborne to the date of late retirement.

The custom of compulsory retirement at an age as low as 65 is thoroughly bad. (The principle of compulsory retirement at a fixed age is itself open to question.) It is obviously in the public interest that everyone remain productive as long as possible. The lower the ratio of non-producers (children, the unemployed, the disabled, the idle, and the aged) to producers, the higher will the general standard of living be for all.

Fixing the retirement age at 65 was more or less satisfactory when it first became general more than 25 years ago. If it was right then it is wrong now — and it *is* wrong now! Today men at 65 are, on an average, as vigorous as those of the previous generation were at 60. The life expectancy after age 65 is constantly increasing. The cost of providing life pensions starting at 65 is getting to be very heavy and may soon be out of the question. The acceptance by industry of this steadily mounting cost is no favour to those workers who do not wish to become idle while they are still vigorous mentally and physically.

The present trend is to make retirement *permissive* at 65 but not compulsory at all — or at least not compulsory until some higher age such as 68, 70 or even 75. This imposes on management the serious responsibility of appraising each employee's efficiency in order to consider the desirability of deferring his retirement. But if management can assess efficiently up to age 65, as it presumably does when it discharges or retains employees, promotes some and demotes others, then why can it not do so after 65?

When retirement is deferred under a "permissive" plan, the late pension is not usually increased to equal the value of the normal pension forborne to the date of actual retirement. If the amount of pension depends on length of service the employee simply gets credit for the additional service. If it is a flat pension, say \$100 per month regardless of length of service, or a final salary pension, say 40% of average salary for the last 5 years, service after 65 will not affect the amount of the pension.

PENSION FORMULA

1. *Salary Service Type*

For each year of membership in the plan the employee earns a "unit" of pension. This unit is some percentage of his earnings, e.g. 1½% or 2%. An employee whose wages are \$300 per month when the year is out will have earned a pension unit of \$4.50. These "units" are accumulated — e.g. for 30 years of service,

assuming constant wages of $300, pension would be 30 x $4.50 = $135.00 per month. The salary service formula usually provides a lower percentage for past service — the most common formula in Canada is 1½% for future service but only 1% for past service. The 1% for past service is often based on current salary multiplied by years of past service.

2. *Final Salary Type*

There are many variations of the final salary type of pension formula. Final salary seldom means exactly that. More often it means the average of the last few years before retirement, such as the last five years or even last 10 years. It may also mean the average of the 5-year period ending five years before retirement.

For most groups a pension of 40% or 50% of final earnings is liberal.

3. *Flat Amount Type*

A flat amount type of pension is one under which all employees get the same pension — say $100 per month. Some minimum service such as 25 years is required. Lesser service down to perhaps 15 years may entitle the employee to a proportionate pension, e.g. for 20 years 4/5 of $100 or $80. This type is quite unsatisfactory if the employees make any significant contributions because after attaining the minimum service (25 years above) the pension does not increase though the employee might contribute for another 15 years. Any flat pension which is not too high for the lowest paid employee will be not much more than an irritant to higher paid employees and executives.

TYPE OF RETIREMENT INCOME

Some plans provide that the pension is payable as long as the employee lives but in any event for not less than 10 years. If the employee died at the end of three years on pension, payments would continue to his beneficiary or to his estate for another seven years. The principle here is right, but 10 years is the wrong period.

Pension payments should cease on death of the pensioner unless

(a) he dies quite soon after retirement so that the payments made to him are not equal to his contributions. In this case payments should be continued until in all they equal his contributions. If employee contributions are returned *with* interest on death before retirement, then on death after retirement payments should continue until they equal the employee's contributions accumulated with interest to the date of his retirement;

(b) he elects, before he retires, a joint life and last survivor annuity. Such an election is very desirable for a married male especially if his life insurance and other resources are limited. The chances are that his wife will survive him.

In some plans the pension is a life income with a 5-year instead of a 10-year guarantee period. The former is an approximation to the period required to return employee contributions with interest ((a) above). The exact return of contributions plus interest complicates the actuarial calculations somewhat, so there is some justification for using five years as a round figure.

On Severance Before Retirement

Each employee should be assured that

he will always receive from the plan at least as much as he paid into it. In Quebec this elementary principle is required by law. In Manitoba it is violated by the government itself.

On severance the employee has the option of

(a) a cash payment of his own contributions — sometimes with, sometimes without interest, or
(b) the paid-up deferred annuity which to date has been purchased by his contributions — in this case always with interest.

It is a requirement in Canada that on severance after long service and at the higher wages the employee receive the full benefit of not only his own contributions but also the employer's. This is called "vesting". In very small firms vesting must be immediate and complete. In firms of six or more employees gradual vesting is common. Many variations are found but the most popular type vests employer contributions to the extent of 10% after 10 years of service plus an additional 10% for each additional year of service. This results in full vesting after 20 years.

On Death Before Retirement

The pension plan should return the employee's own contributions if he dies before reaching retirement age. As long as it makes this return either on severance, death before retirement, or on early death after retirement, an employee who joins the plan and contributes can be sure that he or his beneficiary will get from the plan at least what he paid into it. The treatment of interest on employee contributions should be consistent as between severance, death before retirement, and early death after retirement.

Some plans, mostly uninsured or government annuity plans, allow employer contributions as a death benefit. This is a form of life insurance. But it is not good life insurance and it is costly. The benefit is small in the early years of service. The first year it is equal to *one* employer contribution plus interest. At the younger ages the employer contribution is low, say $50 the first year. But this employer contribution increases and interest accumulates. In the last year before retirement the death benefit may be enormous, running up to $15,000 for a pension of $100 a month and $150,000 for a pension of $1,000 a month. At these higher ages life insurance is expensive.

The need for low-cost life insurance is greater at the younger ages when family responsibilities are heavy and income is lower than at the older ages when the family is grown up. If the employer desires to provide life insurance for his employees he can get much better value for his money if he turns to something more scientific than a return of *his* contributions to the pension plan.

On Disability Before Retirement

Some pension plans have a special provision for some amount of life income for an employee who is totally and *permanently* disabled. Temporary disabilities are almost never recognized under the pension plan.

The vast majority of all total and permanent disability cases occur at the higher ages. Since the early retirement is customarily permitted during the 10 years before normal retirement, this covers ages 55 to 64 (assuming a 65 retirement age). In most groups 80% or more of total and permanent disabilities before age 65 occur after age 55.

The early retirement provision goes a

long way towards handling the permanent disability problem. However, the employer may want to provide for the rare case occurring before age 55 or he may wish to provide a pension which is higher in case of permanent disability than in the case of voluntary early retirement.

A pension which is higher for disability than for early retirement presents a peculiar underwriting hazard that may easily strip the nicest actuarial calculations of whatever validity they might otherwise have. This hazard is that the employer may "presume" total and permanent disability in the case of key employees or executives who become inefficient or unacceptable for reasons other than physical impairment. The disability provision, if it gives more than the early retirement provision, will be a great temptation when it is necessary to "ease out" an employee who has lost his value to the employer for other than medical reasons. This may well be a useful mechanism which, if it is good for the firm and at the same time protects the employee, is entirely legitimate.

If the pension plan is insured, the insurance company can be of great service in working out the mechanics of such a disability provision.

Cost to Employee

In the great majority of cases, employees contribute to pension plans in Canada. This is as it should be for at least two good reasons:

(a) Employee contributions to an approved pension plan up to $1,500 per year are deductible from taxable income;

(b) Generally employee benefit plans to which employees contribute are more appreciated by the employees than plans wholly paid for by the employer.

The most common employee contribution is 5% of salary. Additional optional employee contributions are permitted by the Income Tax Regulations in certain circumstances.

Cost to Employer

In money purchase plans the employer pays for each employee a fixed percentage of his salary, say 5%. This together with the employee's own contribution is used to buy what pension it will. In addition the employer usually pays for past service benefits.

Under fixed benefit plans, such as a salary service plan (e.g. 1½% of salary for each year of service) or a final salary plan (e.g. 40% of average salary for the last five years before retirement) the employer pays whatever the promised benefits cost over and above contributions from the employees themselves. The employer future service cost of a 1½% salary service plan frequently is close to 5% of payroll though this, of course, will depend on the average age of his employee group. Steady increases in salary caused by inflation or other factors will increase the units of pension (say 1½% of $500 instead of 1½% of $300) purchased each year for an employee. In dollars the employer cost will go up, but as a percentage of payroll it is not necessarily increased by even a steep rise in salaries.

In this respect a final salary plan is very different indeed. Sharp increases in salaries can result in fantastic increases in employer cost. This is because under the final salary plan wage increases shortly before retirement catapult pensions upward while the period during which this increase in pension can be paid for is telescoped into the few years remaining to retirement.

III FINANCING

Incidence

PAY-AS-YOU-GO

The idea of industrial pensions probably grew from the fact that some employers did continue to pay a small part of an employee's wages when he stopped working after many years of service. These payments to former employees were charged as a current expense, probably even classified as wages. After a while some rules developed, rules as to eligibility and perhaps as to amount. With the advent of the corporation income tax, the Income Tax Department became interested and a "formalizing" process began. By this time the arrangement could be called a "pension plan". Payments were, however, still made directly to the pensioners out of current revenue on a "pay-as-you-go" basis.

Charging these payments as and when made is "actuarially" sound enough, but involves very bad accounting. Good accounting requires that expired usage cost of plant and equipment be charged against revenue as it occurs. This treatment of fixed asset costs is not just an accounting fetish; it is essential if an employer is to know his true current cost of production. If he does not know it and therefore does not take account of all his current costs in pricing his product for sale, but instead defers some of them into a later cycle of production, his selling price in that later cycle will have to be higher than it otherwise would have been.

At that time his selling price may not be competitive with employers who met their current costs as they arose.

Pensions are no different. Their cost should be met as it arises while the employee is in service, not decades later in a production cycle to which the employee, now a pensioner, contributes nothing. Though there still are some "pay-as-you-go" plans in existence, they are almost universally recognized as outmoded.

CURRENT FUNDING

Current funding of pension costs is analogous to the customary accounting treatment of fixed asset costs. The best example is a salary service plan under which an employee for each year of service earns a unit of pension credit, e.g. 1½% of his salary. An employee age 35 whose salary is $300 per month earns during a year of service the right to a "unit" of $4.50 of pension commencing 30 years later when he attains age 65. Current funding would mean paying in the year the employee earns this credit the single sum which when accumulated with interest to age 65 will be sufficient to pay the employee $4.50 a month for the rest of his life.

If the pension plan is "insured" the insurance company states what single premium it requires to guarantee the employee this unit of pension. Once the employer pays this amount to the insurance company he has no further liability with respect to it.

If the plan is not insured the employer pays into the pension fund the amount which his actuary *estimates* will, with such interest as the fund can likely earn, be sufficient. If the actuary under-estimates the amount required, which experience shows is most often the case, then one day — probably not until many years later — the condition of the fund will reveal that it was not "current funded" after all but that unforeseen costs

have in fact been deferred and must now be met long after they were incurred.

When a plan is first started, there usually are some past service costs to be met. This, of course, has its origin before the plan is inaugurated, so that there is nothing that can now be done but to fund this "dead weight" out of current surplus or future revenue.

TERMINAL FUNDING

Terminal funding is an arrangement under which pension costs are deferred until the employee actually retires but at that time the employer pays in one sum the entire cost of the lifetime pension the employee is entering on.

There is little to recommend this method of funding except perhaps as an adjunct to a current funded plan to be used only occasionally when it seems necessary to make minor adjustments in the plan. Instead of dragging out the cost of such minor adjustments over 10 years for treatment like past service costs, it would be eminently more practical to treat it as terminal funding.

Terminal funding is used very little in Canada.

Employer Commitments

FIXED COMMITMENT FUNDING

If the employer agrees to pay 5% of payroll into the pension plan he has made what is referred to as a fixed pension commitment, in this case of the "money-purchase" type.

If the employer agrees to pay the balance after employee contributions of the cost of a "salary service" plan of 1½% of salary, he has also made a fixed commitment. The "final salary" type of plan is also a fixed commitment.

Many pension experts believe that to get employee satisfaction it is necessary for the employer to undertake a clear-cut fixed pension commitment. In the long run this commitment will be honoured only if the employer's business is basically profitable. The year by year profits may fluctuate and there will be years of no profit and years of loss, but by and large there has to be a profit pattern or the business itself, let alone the pension plan, will cease to exist. In other words the pension plan really rests on profits. This being so, why not tie payments for pensions *directly* to profits?

PROFIT SHARING FUNDING

Profit sharing as such is a vast and fascinating subject. It is already quite widespread in the United States. Its development was not stimulated in Canada to the same extent because it had not the favoured tax position given it in the United States.

The inescapable fact that labour and capital are partners is stressed by both labour and management advocates of free enterprise. But both usually think of the partnership stopping short of sharing its results. Capital wants the profits partly because labour is reluctant to share in any losses.

Here is one instance in which it may be possible to have the best of two worlds. Without affecting wages, profit sharing with its incentive and employee relations value, can be adopted with advantage also to the employer. Instead of a fixed pension commitment, why not tie it directly to profits?

When profits are good, a lot of money goes to the employees' pension accounts. When there are no profits only the minimum (1% of payroll) required by the Income Tax Regulations is contributed. In the meantime the employees con-

tribute their usual 5% of salary. The pension his own contributions buys will be augmented in proportion to the profits of the business. This gives the employee a very personal interest in profits. At the same time it relieves the employer of a fixed pension commitment, profits or no profits.

INSURED V. UNINSURED PENSIONS

In my opinion all pension plans should be insured. The idea of insuring pension promises is relatively new; the uninsured (self-administered) idea is much older. However, all new ideas, no matter how superior they are to the old, need time to gain common acceptance.

It is not possible here to go into the many advantages of insured pensions. If an accountant or his client wants to explore them he can secure literature from almost any insurance company. I have published two pamphlets, "The Advantages of Insured over Uninsured Pension Plans" and "The Future of Pensions in the National Interest", and there are others available.

Let it, therefore, suffice to deal briefly here with only one common misconception of the difference between insured and uninsured pension plans. This is as to interest earnings. Because the insurance company uses some such interest rate as 3¼% or 3½% in its premium computations, it is supposed that this is all the interest the insured pension fund will receive. Such, of course, is not the case.

Insurance policyholders, group and individual, get the benefit of insurance company high interest earnings. Segregated trusteed funds in theory should not be expected to equal the high interest earnings possible for insurance companies, nor have they in practice. With only an occasional exception the actual interest earned by uninsured trusteed pension plans is significantly *lower* than the actual interest credited to insured pension plans. In consequence the uninsured plans are more costly than insured plans and, in addition, lack many other very real advantages. This is as it should be. A new product which is both better and cheaper is what those of us who have faith in free enterprise expect of it.

PERSONNEL SELECTION: OLD STYLE

Many will recognize the name Stephen Potter as the author of the well-known *Art of Lifemanship* and *Art of Gamesmanship,* but until he attended a dinner of the Birmingham and District Society of Chartered Accountants on March 3 (reported in *The Accountant,* March 12, 1955) few realized that he has had associations with the accounting profession. In proposing the toast to the Institute of Chartered Accountants in England and Wales Mr. Potter recalled that his father had been a partner in a firm of chartered accountants.

> "I served six months in the office under my father," he said, "then he reviewed my work, heard me talk on the subject and said: 'My boy, I think you are more suited to a life of the arts.' "

It seems that he took his father's advice literally and since that time has devoted himself to the arts — especially the art of how to appear four-square while always remaining one-up!

Accounting Research

By Gertrude Mulcahy, B.A., C.A.
The C.I.C.A. Research Department

RELIANCE UPON THE WORK OF OTHER AUDITORS

AN auditor frequently relies upon the work of other auditors. For example, in forming his opinion on consolidated financial statements, he may make use of the financial statements and reports which other auditors have prepared for some or all of the subsidiary companies. The degree of reliance will vary and must be determined by the parent company's auditor according to the circumstances of each particular case.

Where the subsidiary companies concerned are relatively insignificant to the group as a whole, there is no particular problem. Under these conditions, the parent company's auditor need not hesitate to express an opinion on the consolidated statements provided he has received financial statements which appear to be in order and which have been reported upon by auditors whom he believes to be reliable. However, if the subsidiary companies represent a significant proportion of the consolidated net assets and combined earnings, the principal auditor's position is more complex. His course of action depends primarily on the degree to which he is prepared to accept the responsibility for the information to be presented in the consolidated statements. In Canada, it is questionable whether the shareholders' auditor has any choice as to the extent to which he may or may not accept responsibility. The Companies Act (Canada) makes no provision for the delegation of the responsibilities imposed upon the shareholders' auditor by the terms of his appointment. Is the parent company's auditor fulfilling his legal obligations to the shareholders if he denies responsibility for a significant portion of the information upon which he is reporting? The answer to this question depends, in part, on how far such qualifications can be carried before the auditor reaches the position where he is unable to form an opinion on the statements as a whole.

This particular problem has been relatively unexplored in Canada to date. A study of it should ask among other things:

(1) How does an auditor decide what reliance he can place on the work of another?

(2) What procedures should be adopted by the parent company's auditor to place him in a position to accept full responsibility?

(3) What disclosure, if any, should be made in the report where the auditor is accepting full responsibility?

(4) Does the principal auditor actually have an option either to accept or to deny responsibility where the amounts involved are significant?

Consideration of Problem in the United States

In the United States there have been two authoritative statements dealing

specifically with the reliance placed on the work of another auditor.

Rule 6 of the Rules of Professional Conduct of the American Institute of Accountants sets the standards for such reliance. It reads:

> "A member shall not sign a report purporting to express his opinion as the result of an examination of financial statements unless they have been examined by him, a member, or an employee of his firm, a member of the Institute, a member of a similar association of a foreign country, or a certified public accountant of a state or territory of the United States or the District of Columbia."

In setting the standards for reporting, Rule 2.05 of Regulation S-X of the Securities and Exchange Commission requires:

> "If, with respect to the certification of the financial statements of any person, the principal accountant relies on an examination made by another independent public accountant of certain of the accounts of such person or its subsidiaries, the certificate of such other accountant shall be filed (and the provisions of rules 2.01 and 2.02 shall be applicable thereto); however, the certificate of such other accountant need not be filed (a) if no reference is made directly or indirectly to such other accountant's examination in the principal accountant's certificate, or (b) if, having referred to such other accountant's examination, the principal accountant states in his certificate that he assumes responsibility for such other accountant's examination in the same manner as if it had been made by him."

(Rules 2.01 and 2.02 mentioned above refer to the requirements as to the accountant's qualifications and accountant's opinions respectively.)

An excellent paper entitled "Reliance Upon Work of Other Auditors" was presented by Mr. J. Woodrow Mathews, C.P.A. at the 64th annual meeting of the American Institute of Accountants in October 1951. In considering how an auditor decides what reliance he can place on another, Mr. Mathews stated:

> "I think after the auditor has determined that the other auditor is duly qualified and the possessor of a satisfactory general reputation in the profession, he sees that the client furnishes the other auditor with appropriate instructions for the work to be done and arranges for the other auditor to furnish to him directly copies of reports and memoranda. Furthermore, where the work of the other auditor is material, the principal auditor may consider it desirable to determine generally, either in conference or by correspondence, that the other auditor is carrying out the examination in accordance with generally accepted auditing standards. This would not usually involve a review of the other auditor's papers."

The late R. H. Montgomery, C.P.A. was of the opinion that in such circumstances the auditor "should disclose in his report that he has not examined the financial statements of certain subsidiaries, but has received reports of other independent public accountants, and that his opinion of the consolidated financial statements is based on such reports". (*Montgomery's Auditing*, 7th ed., p. 63).

In a discussion of examples of varia-

tions in "The Modern Short Form Audit Report" appearing in *The Journal of Accountancy,* November 1953, J. H. Myers, C.P.A. pointed out that there does not appear to be any uniformity of location and wording of the disclosure of the reliance on other auditors. He suggested that observations as to the use of financial statements of subsidiaries examined by other accountants, which appear to be mere additional comments (required by the S.E.C.) rather than scope exceptions, should be placed in a separate paragraph of the report rather than in the scope paragraph.

Mr. Mathews also commented on this aspect of the problem as follows:

> "I found that it is rather general practice to state in the scope paragraph of an opinion that examinations have been made by other auditors. In some cases this statement of fact is supplemented by percentages or dollar amounts to indicate the extent of the assets, or assets and income, involved in the statements examined by another auditor.
>
> "It is my view that no reference to another auditor is required in the opinion paragraph unless a clear-cut exception is to be taken, because it seems obvious when an opinion is expressed that the accountant doing so is basing his opinion on his examination of certain statements and his review of statements examined by another auditor as described in the scope paragraph."

Referring to prospectus statements to be filed with the S.E.C., the late R. H. Montgomery, C.P.A. has suggested that the American accountant may or may not refer to examination of the Canadian subsidiary by Canadian accountants. If he does, he may say "based upon our above outlined examination and the aforementioned report of Canadian chartered accountants". He also has suggested that if the American firm could assume the same responsibility for the audits of other accountants as though the American accountants had made the examination, there would be no point in mentioning that part of the examination had been made by others.

Some English Views on the Subject

In November 1952, the Council of the Institute of Chartered Accountants in England and Wales presented specific recommendations relating to the provisions of the Companies Act, 1948. Incorporated in them were the joint opinions given by counsel with respect to matters of difficulty affecting accountants and auditors. In considering the auditor's responsibility relating to consolidated statements, the opinion of counsel was cited as follows:

> "Under paragraph 4, Ninth Schedule to the Companies Act, 1948, the auditors of a holding company must state in their report whether in their opinion the group accounts have been properly prepared in accordance with the provisions of the Act so as to give a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries dealt with thereby so far as concerns members of the company. The auditors of the holding company must take responsibility for accepting for the purposes of group accounts the balance sheets and profit and loss accounts of subsidiaries. This may involve either relying upon the reports of the auditors of the subsidiaries or making such

inquiries regarding the subsidiaries' accounts as they deem to be necessary. It is for the holding company's auditors to decide, as reasonable men, which course it is necessary for them to take for this purpose."

A form of auditor's report was recommended for use in cases where consolidated accounts were to be submitted. The suggested wording included a statement to the effect that certain subsidiary companies had not been audited by the parent company's auditor. In addition, it was recommended that the auditor qualify his expression of opinion in this respect by the use of the words "Subject to the foregoing". Counsel was of the opinion that:

" . . . . the holding company's auditors cannot, in our opinion, avoid responsibility as regards the accounts of subsidiaries not audited by them merely by indicating in their report that the information regarding subsidiaries is based upon accounts of subsidiaries not audited by them.

"Nevertheless, whilst the holding company's auditors should take all reasonable steps to satisfy themselves with regard to the accounts of subsidiaries not audited by them, we recommend that for their own protection they should qualify their report in respect of such accounts in the manner indicated in the forms of report."

Sir Russell Kettle, F.C.A., a member of the Council of The Institute of Chartered Accountants in England and Wales, made reference to this aspect of the auditor's responsibility in his article, "Auditor's Report under the Companies Act, 1948 and Qualifications thereof", which appeared in the March 6 and March 13 issues of *The Accountant*. In discussing the responsibility with respect to returns received from branches not visited by the auditor, he stated:

"The legal position of auditors in the event of the truth and fairness of the returns — unaudited or audited by another firm — being challenged, has not yet come before the Courts. Their position in law seems to be similar to that existing when group accounts incorporate the accounts of subsidiaries not audited by them, because in the one case they accept accounts of subsidiaries and have no statutory right to go behind those accounts and examine the books, while in the other case (assuming the requisite circumstances to exist regarding the branch) they are not required to examine or audit the books."

Sir Russell commented on the recommended wording of the auditor's report:

"The qualification in question consists of those dreadful words, "Subject to the foregoing . . . " which are considered by some auditors to cast a slur upon fellow practitioners. In practice, this qualification is frequently omitted. What are "all reasonable steps to satisfy themselves" must depend upon the circumstances of each case both as regards subsidiaries and branch returns."

He cited examples of the numerous ways in which auditors appear to disclaim responsibility for accounts of subsidiaries not audited by them and went on to say:

"Unless the names or numbers of

subsidiaries are disclosed, the references to a specific number whose accounts have not been examined by the auditors of the holding company is often of little or no assistance to shareholders: the extent to which such accounts enter into the group accounts can, of course, only be seen if the relative figures are given."

Analysis of Disclosure in Auditor's Reports on Canadian Companies

Of the 280 annual reports reviewed for 1952, 139 included financial statements prepared on a consolidated basis. In 109 cases, the parent company's auditor expressed his opinion without reference to reliance having been placed on the work of other auditors. Where one auditor acts for all the component companies, there would be no reason for such a reference. On the other hand, it is altogether likely that many accountants, accepting full responsibility for the financial statements, find no reason to mention that part of the examination has been made by others. Presumably they will have undertaken such investigation of the work carried out by other auditors as they consider necessary for their expression of opinion on the statements of the group. If they had not, they certainly would not be willing to accept the responsibility.

Although there appears to be little uniformity in wording, all the references to work done by other auditors were set out either as part of the scope paragraph or as a separate paragraph. Of the 30 reports concerned, 6 merely included a statement to the effect that the accounts of some of the subsidiaries were examined by other auditors. An additional 2, with a similarly worded reference, identified the other auditors as the internal auditors of the parent company. There was no indication in any of these 8 reports as to action, if any, taken by the parent company's auditors with respect to the financial statements and auditor's reports of these subsidiaries. In the remaining 22 reports, the auditor referred specifically to the audited financial statements and auditor's reports of the subsidiaries whose accounts were examined by other auditors. The following summarizes the general categories of wording adopted in this respect:

7—the audited financial statements and auditor's reports thereon were *furnished,*

5—the audited financial statements and auditor's reports thereon were *reviewed,*

5—the audited financial statements and auditor's reports thereon were *accepted,*

5—the audited financial statements and auditor's reports thereon were *accepted for inclusion in the consolidated statements.*

It was interesting to note that none of the auditors who made reference to work carried out by other auditors specifically qualified their opinion on the consolidated statements by the use of the words "Subject to the foregoing . . ." On the other hand, several obviously meant to disclaim responsibility for the accounts of subsidiaries not audited by them. For example, 8 of the auditors included in the opinion paragraph the words "based on our examination and the reports of other auditors". An additional 4 stated that the expression of opinion was "based on our examination" or "based on such examination". In 11 cases the auditor expanded his report

by adding, "as shown by the books of the company and the audited financial statements of the subsidiary companies which we did not examine".

Only 2 of the 30 reports concerned included an indication of the relative significance of the subsidiaries to the consolidation. The subsidiary auditor or auditors were identified by name in only 6 reports. In 12 instances the name or names of the subsidiary companies concerned were disclosed in the report on the consolidated statements.

The following extracts from auditor's reports have been selected to demonstrate the variety of presentation used by Canadian accountants. Some of them, like Hamlet, seem to be standing on the brink of indecision crying:

To qualify or not to qualify that is the question,
Whether 'tis nobler to have the reader suffer
The slings and arrows of ambiguity,
Or to recognize responsibilities,
And by clear expression, accept them.

EXCERPTS FROM PUBLISHED AUDITOR'S REPORTS — 1952

Example 1

We have examined the books and accounts and Balance Sheets of .... Limited and seven of its wholly owned subsidiary Companies. We have also had produced for our inspection the Balance Sheets of other wholly owned subsidiary Companies (of which three are audited by ...., Chartered Accountants, two by ...., one by ...., Chartered Accountants and one by ...., Chartered Accountants).

Based upon the examinations made by us and the opinions expressed in the reports of the other auditors above mentioned regarding certain subsidiaries, the figures for which have been included on the responsibility of such auditors, we report that we obtained all the information and explanations we required and that the attached Consolidated Balance Sheet is, in our opinion, properly drawn up so as to exhibit a true and correct view of the state of the affairs of .... Limited and its wholly owned subsidiaries at ...., 1952, according to the best of our information and the explanations given to us and as shown by the books of the Companies.

Example 2

We have examined the Balance Sheet of .... Limited with the books and vouchers relating thereto and have had produced for our inspection the Balance Sheets of the wholly owned subsidiary companies, ... Limited and .... Limited, audited by ...., Chartered Accountants, and the Balance Sheet of the wholly owned subsidiary company, ... Limited, audited by ...., Chartered Accountants.

In accordance with The Companies Act (Canada) we report that we have obtained all the information and explanations we have required and that, in our opinion, the above Consolidated Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the affairs of .... Limited and its wholly owned subsidiary companies at ...., 1952, according to the best of our information and the explanations given to us, and as shown by the books.

Example 3

We have examined the foregoing Balance Sheet of your Company and Subsidiaries consolidated therein as at ...., 1952, and have obtained all the information and explanations we have required. Our examination has included such tests of accounting records at the principal offices of the Company and its subsidiaries and such auditing

procedures as we considered necessary in the circumstances. We have accepted the reports of auditors of certain subsidiaries whose accounts have not been reviewed by us.

Based on such examination we report that the foregoing Consolidated Balance Sheet is, in our opinion, properly drawn up so as to exhibit a true and correct view of the combined position at that date, according to the best of our information and the explanations given to us and as shown by the books of the companies.

Example 4

We have examined the Consolidated Balance Sheet of .... Limited and its subsidiary companies as at ...., 1952 and the related Consolidated Statements of Profit and Loss and Surplus for the year ended on that date, and have obtained all the information and explanations which we required. In connection with the accounts of the companies examined by us, our examination included such tests of the accounting records and supporting evidence and such other procedures as we considered appropriate in the circumstances. The Balance Sheet as at ...., 1952 and related statements of Profit and Loss and Deficit of .... Limited with report thereon of ...., the auditors of that Company, have been accepted by us for inclusion in the accompanying consolidated accounts of .... Limited and its subsidiary companies.

We report that, in our opinion, the accompanying Consolidated Balance Sheet is properly drawn up so as to exhibit a true and correct view of the financial position of the combined companies as at ...., 1952 and the related Consolidated Statements of Profit and Loss and Surplus present fairly the result of operations for the year ended on that date, according to the best of our information, the explanations given to us and as shown by the books of the Companies.

Example 5

We have examined the books and accounts of ...., Limited, and .... Limited, for the year ended ...., 1952, and have received all the information and explanations we have required. Our examination included such tests of the accounting records and other supporting evidence and such other procedures as we have considered appropriate in the circumstances. The accounts of ...., Ltd., as at ...., 1952, have been reported upon by the auditors of that Company, ..., Chartered Accountants. In our opinion, the attached Consolidated Balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of the combined affairs of the Companies according to the best of our information and the explanations given to us and as shown by the books of the Companies and the audited accounts of ...., Ltd.

Example 6

We have examined the consolidated balance sheet of .... Limited and Canadian subsidiary companies as at ...., 1952, and the consolidated statements of profit and loss and surpluses for the year ended on that date, and have obtained all the information and explanations which we required. Our examination of the accounts of .... Limited and of the subsidiary companies of which we are the auditors, included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as we considered necessary in the circumstances. The accounts of one subsidiary company have been examined and reported upon by the auditors of that company.

In our opinion, based on our examination and the report of the other auditors, the accompanying consolidated balance sheet and related consolidated statements of profit and loss and surpluses are properly drawn up so as to exhibit a true and correct view of the combined state of affairs of the companies at ...., 1952 and the results of their combined operations for the year ended on that date, according to the best of our information and the explanations given to us and as shown by the books of the companies.

RELIANCE ON OTHER AUDITORS

Further Comment by L. G. Macpherson,
Director of Research, C.I.C.A.

UNDER Canadian legislation, the shareholders' auditor of a parent company is directed to make a report on every balance sheet laid before an annual meeting. Such a balance sheet may consolidate the accounts of subsidiary companies with the accounts of the parent company; but the the auditor of a parent company does not, as such, have any right of access to the records of the subsidiary companies. For various reasons another person may have been appointed auditor of a subsidiary company. The parent company auditor is then faced with the problem of determining the degree to which he is entitled to rely on the report of the auditor of the subsidiary.

The problem can be narrowed only slightly by establishing its limits. There can be no doubt of the right of reliance where the parent company auditor has arranged with the subsidiary auditor for the latter to act as his agent, conducting the audit of the subsidiary in accordance with his directions and in full consultation with him. At the other extreme, where there is no communication between the auditors, the parent company auditor will feel obliged to qualify his report on the consolidated statement, since he has not obtained information as to inter-company profits, consistency in accounting principles applied by the parent company and subsidiary respectively, the scope of the audit of the subsidiary company, and so on. Even where he has the highest respect for the integrity and professional competence of the subsidiary company auditor, he will be placed in the position of qualifying his report in the absence of such information.

Branch Reports

The necessity of relying on other auditors occurs in other circumstances as well as in the case of subsidiary companies. A common example is found in the company branch located in a remote place, especially in a foreign country. Here the auditor of the parent company may not be licensed to undertake a professional engagement in the foreign country, or other legal encumbrances may exist. Perhaps it is a matter of good public relations to continue to engage the local auditor. Often the local auditor will act as agent or perhaps as employee of the shareholders' auditor, and the problem is thus resolved. But this arrangement is not always possible, and the type of audit report to be submitted to the annual meeting becomes a major question.

Responsibilities and Duties

The scope paragraph of the standard form of audit report recommended in Research Bulletin No. 6 indicates that the auditor's examination included a general review of accounting procedures and such tests of accounting records and other supporting evidence as the auditor considered necessary in the circumstances.

It can, perhaps, safely be said that an auditor who signs such a report without amplification, and who has incorporated the figures of a subsidiary company's

financial statement reported on by other auditors, has received from other auditors whatever information and explanation he has required in addition to their audit report, and that he has made a general review of the accounting procedures either through the other auditors or directly. Unless he has examined the records of the subsidiary, he evidently has not considered necessary any other tests of the accounting records and other supporting evidence. The auditor, in other words, has had such communication with the other auditors as to satisfy himself that he can safely rely on their report, and he has obtained in that way all the information needed for his purpose. He is assuming responsibility for his opinion that the consolidated statements "exhibit a true and correct view" or "present fairly".

In arriving at the conclusion that he is in a position to express a clear opinion on the consolidated statements the auditor has undoubtedly been faced with certain questions of procedure. First, he has had to decide what information he should obtain in addition to that provided by the subsidiary statements. Then the question of the extent and nature of his communication with the subsidiary auditor and the exent of any additional verification must be decided; and finally the effect of his communication with the subsidiary auditor must be considered, since that very act may possibly have eliminated any right he may have had to deny responsibility for the information derived from the subsidiary reports. Having reached his decision in these matters, it is quite likely that the auditor will proceed much farther than is proposed in C.I.C.A. Research Bulletin No. 2:

"If, for certain subsidiary companies and branches, he relies on the reports of other accountants, he should have direct communication with such other accountants and advise them that he will rely upon their opinions in incorporating the figures reported upon with those examined by himself in the preparation of his report on the prospectus under consideration."

Qualifications

Perhaps in every case where the auditor describes his reliance on the reports of other auditors he is seeking to limit his responsibility; but the wording of some of the examples cited by Miss Mulcahy may raise a number of questions, particularly in the minds of laymen. When the scope paragraph indicates that the parent company auditor did not examine the records of a subsidiary company, is that information a qualification of opinion, based on the limited scope of the audit? Is the parent company auditor assuming responsibility for the subsidiary company's figures incorporated in the consolidated statements? If not, should not the report indicate the relative significance of those figures in the totals reported? Are the answers the same if the reference is made in a separate paragraph instead of in the scope paragraph?

If the auditor indicates that he has "accepted" the report of other auditors, does this mean that he has found them acceptable? Or does he accept the report but not the responsibility?

When the auditor has referred to the fact that the subsidiary company's records were not examined by him but have been reported upon by the auditor of that company, what is the significance of the phrase "based on such examina-

tion" or "based on such examination and the report of the other auditors"? Since the words "based on such examination" were a part of the approved form of report recommended by the AIA up to 1941 (at which time they were dropped from the recommended form,) they cannot of themselves be said to indicate a qualification. But when they follow words which indicate clearly that the scope of the audit has been limited, they may gain the strength of qualifying words rather than indicate obvious facts.

No attempt has been made here to answer the questions that have been raised. Some of the questions have much wider implications than their application to consolidated statements alone. They have been raised in the hope that efforts will be stimulated to clarify the answers, for if that is accomplished a forward step will have been taken in auditing practice and in report-writing.

The Research Department would like to receive comments or suggestions concerning this subject.

ON BEING AN EXPERT WITNESS

In a letter to the editor, published in *The Accountant,* March 5, 1955, R. J. Blackadder of London, England recalls a letter he received from his father after telling him that he, as one of the qualified accountants in a firm of chartered accountants, had given evidence on behalf of a client.

The father's letter read:

> "I am pleased to see that you have undergone the ordeal of the witness-box upon questions of accountants, as this trial (the witness-box) shows a man's clearheadedness, and if he undergoes it with credit he is sure of promotion as solicitors and others in Court notice it. The examination and checking of ledgers etc. requires a clear head too, but that is done in private and is not seen, besides time can be taken for consideration, whereas in the box the answers require to be distinct with little time for consideration; and the ready man is the successful man.
>
> "I may repeat to you the instructions the late Sir . . . . . . gave me when I began to appear in the witness-box: (1) don't lounge in the box — stand straight up, and look the barristers and judge respectfully in the face; (2) never give a smart answer: invariably reply quietly and civilly and as short as you can with distinctness; (3) don't hurry your answers, always take a little time to repeat the question to yourself and give your reply speaking slowly.
>
> "I have endeavoured to follow these instructions with only moderate success, and my experience has proved to me that they are sound."

Students Department

By J. E. Smyth, C.A.
Associate Professor, Queen's University

When Are Marketable Securities Not Current Assets?

NOT so long ago our roving eye came to rest upon a balance sheet which included among its current assets "marketable securities" of about one and a half million dollars. We checked back through our file of annual reports for the company and found that in times past this item had been segregated for presentation on the balance sheet between Canadian and provincial government bonds and "other investments" and that still previously, the "other investments" were identified on the balance sheet as shares in another company in the same line of business. The company has always shown the total market value of these securities, but there appears to have been a gradual reduction in the information disclosed about their nature; and they are now much the most important single item among the current assets.

We have trouble reconciling the method of disclosure on the most recent balance sheet with the recommendations of Bulletin No. 1 of the Committee on Accounting and Auditing Research of the Canadian Institute of Chartered Accountants. That bulletin recommends that the description "marketable securities" should "include only securities which are capable of reasonably prompt liquidation within the present plans of the company, and which represent more or less temporary investment of surplus funds". The bulletin also recommends, "Investments which are not readily realizable either as a result of market conditions or business policy should not be included in current assets." The company has shown marketable securities in relatively large amount among its current assets for many years and the question must naturally arise whether the management does not in fact regard these securities as being more in the nature of a permanent (non-current) asset than of a current asset. Moreover, the company's "marketable securities" may still include an investment in the other company, though this is something one cannot be sure about because of the present degree of disclosure.

PUZZLE

Three hobos, Bo, Joe and Mo left the train on the outskirts of Kelowna, B.C. looking for shelter for the night. They found a storage shed on a nearby farm, entered, and prepared for a good night's sleep. Bo, however, was hungry and couldn't sleep, so he arose and while rummaging around found a barrel of apples. He discovered that if he ate one they could be divided equally. He ate one, then consumed his one-third share and went back to sleep. A few

hours later Joe awakened from hunger, discovered the apples and found that if he ate one they could be divided equally between the three. He ate the extra apple and then consumed his share and went back to sleep. Mo awakened, went through the same ritual as the other two and returned to his slumbers. In the morning the three went to the barrel, counted the apples left and found that if they threw one away, each would get an equal share. They threw away the extra and ate the rest. How many apples did each man eat?

(Submitted by Mr. D. B. Wallace, Calgary, Alberta.)

SOLUTION TO LAST MONTH'S PUZZLE

Suppose that the three young men are called A, B, and C, and that A is the winner.

When the three men were put in the room together, A immediately hit upon the following method of determining the colour of the patch on his back. Rather than prove positively that the colour of the patch was either white or black, he would solve the problem by disproving one or the other. He is able to see that each of B and C has a black patch on his back, and reasons as follows:

"Either I have a white patch or a black patch on my back. Suppose that I have a white patch, what then would be the consequences?

"The second young man, B, then sees my white patch and C's Black patch. Thereupon B would know what colour patch he has, if he were to use his powers of reasoning even to the slightest degree.

"B would know the colour because he would reason as follows: 'Since A has a white patch on, if I had a white patch also, C would then walk out of the room as the winner, as he would see two white patches upon the backs of A and B thus leaving him, unconditionally, with a black patch. However C is not walking out, therefore I must have a black patch."

"However," thinks A, "B also is not walking out, therefore I cannot have a white patch on my back. Therefore I must have a black patch on my back."

Thereupon A walked out of the room and declared himself the winner.

CORRESPONDENCE

Kitchener, Ontario

Sir: In times of rising prices such as the past fifteen years much pressure seems to be put upon the accountant to sanction higher depreciation charges on older fixed assets. These assets were purchased in times of low prices and thus yield low depreciation compared with new machines. The cheapening of the dollar has brought this about. We are in effect depreciating an asset purchased 20 years ago at about half the rate originally calculated as necessary. This is realized by most accountants and a solution to the problem is being sought. The solution is somehow to offset the fluctuating value of the dollar.

The simplest way is to find some unfluctuating base and what is less fluctuating than the cost of an hour of labour? The price of an item in dollars reflects only the cost-in-dollars of the

labour that went into the item. The cost of a pencil comprises the cost of men to haul the lumber from the woods, to operate the machine which made it, to make the machine, to make the steel for it , and to mine the iron. In short, all costs are labour costs.

If the cost, in terms of dollars of labour, goes up, the cost of the item manufactured goes up. Could we not then use a unit of labour — say one hour — as a base for valuing assets? To ascertain the average cost of an hour of labour over the whole country would be virtually impossible, but to find this average cost throughout an industry, or better, in one company, is relatively simple. One might simply take the mode of all hourly-rated employees on the middle day of the year — say in a particular plant this is $1.75 in 1954. Suppose then that in 1939 the mode was $.75 and in 1964 it would be $1.50.

If a business purchased a fixed asset in 1939 for $10,000 with an estimated useful life of 25 years and negligible scrap value, the conventional depreciation charge would be $400 a year. If the original cost of the plant was converted into hours of labour, it would represent 13,333 ($10,000 ÷ $.75) hours. The annual depreciation charge would be 533 hours or in 1939, $400. But in 1954 when the modal wage was $1.75 the annual charge would be $933 and in 1964 at $1.50 it would be $800. Thus in 25 years the cost of the asset would be written off in real value, not just dollar value.

To carry this method through, one would have to convert the value of certain of the assets shown on the books from dollars to hours of work at the going rate at the time of purchase. The conversion would include fixed and intangible assets and capital and retained earnings. (Liabilities, no matter when incurred, are payable in the current dollar. The fluctuation is not great enough to require conversion of current assets.)

In the year-to-year operation of this system, revenue and expenses would have to be recorded in dollars, and the depreciation charge therefore converted to dollars. The net income thus calculated would be carried into retained earnings in dollars as well as in hours of work at the then prevailing rate. Fixed assets, and proprietorship, which are on the books in terms of last year's dollar as well as in hours would be converted to the current dollar and the difference would go into a balancing account which in itself was meaningless in so far as interpretation was concerned, labelled "Accumulated dollar fluctuation" or something similar.

Each business would have a different rate of conversion but the net effect would be similar since labour costs fluctuate fairly evenly throughout industry. Thus even the method of calculating this rate need not be uniform though it must be consistent within the business.

The balance sheet would then show the value of all assets in current dollars, and the total retained earnings and capital in the current dollar. At present these figures are an accumulation of completely different rates with really little significance. Earnings of 1910 may be in the retained earnings account.

R. V. FAST
(*Student-in-accounts*)

Editor's reply: The suggestion made in the above letter is, we take it, an attempt to meet an objection that has often been raised to the use of a general price index in converting the accounts of an individual business enterprise to a current

dollar basis: that the general price index is drawn from the behaviour of a wide variety of prices throughout the whole country and does not necessarily describe the particular prices that affect any single business. As the writer notes, "each business would have a different rate of conversion" and it is at least to be said for his method that the price data to be used for the purpose of conversion are within the experience of the business in question.

It is, of course, much easier to criticize proposals for the adjustment of accounts to a current dollar basis than it is to offer constructive suggestions of one's own. We do have, however, one or two observations to make about the method suggested above. We are not sure that it would always be easy to obtain a meaningful "average" price of labour even within a single business, because of the different types of labour employed by a business, and the tendency of the proportions of each type required, to vary over time. A second point would be that the particular types of labour required to manufacture fixed assets would probably not be the same as those employed by the business which uses the fixed assets. We have then to ask whether the conversion of the original cost of fixed assets into current dollars by reference to changes in the price of labour employed will have the effect of expressing the original dollars of cost in terms of their current *purchasing power equivalent.* (This is quite a different matter from expressing fixed assets in terms of their *replacement cost;* there are some who argue that purchasing power provides the better criterion.) Whether such a conversion would produce this result or not would, we think, depend upon whether changes in the average price of labour employed by the business reflect accurately changes in the purchasing power of money for the business in question. In answering this question, the size of the labour bill, relative to other costs incurred by the business, would be relevant. In any case, we do not think that the method of conversion suggested would indicate the current replacement cost of the fixed assets because of the different types of labour required to manufacture the fixed assets and because of technological changes since the fixed assets were purchased.

We will welcome discussion of this point by other readers.

Windsor, Ontario

Sir: Your comments in the Students Department for March 1955 on the troubles students have in understanding partnership drawings are by no means limited to students. I find business men, accountants, and lawyers equally confused, particularly when the word "wages" is used instead of "drawings", as is often the case. Many partnership agreements refer to "wages" and the financial statements prepared by the accountants show these "wages" as an expense instead of an allocation of profits. In a case before the Income Tax Appeal Board last fall, the solicitor for the Crown argued that, since a partner in an enterprise had admitted receiving wages in a calendar year and income from "office or employment" was taxable in the calendar year, the income was properly assessed in that year, not in the business year ending in that calendar year; all this because the word "wages" was used both in the partnership agreement and in the operating statement. As that was the Crown's only argument on that phase of the case, it will be interesting to see the decision; it is difficult

to see how a partner can be an employee of himself.

As means of showing more clearly the proprietor's, partners', or shareholders' interests in their business, the latter only with private companies, we have for some time adopted the practice of taking off an operating profit figure before depreciation (capital cost allowance), remuneration to owners, their wives, etc. (including any amounts paid to such persons as interest on indebtedness or rent), and before income taxes, and then showing those items detailed below before the calculation of the net operating profit before income taxes. This gives the owners of the business a clear picture as to their net cash profits, without several involved calculations and is particularly useful as the capital cost allowances these days very rarely bear any resemblance to the actual depreciation and, in any event, the capital cost allowances do not affect the net improvement in cash earnings.

F. LORENZEN, C.A.

PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by qualified accountants and reflect the personal views and opinions of the various contributors. They are designed not as models for submission to the examiner, but rather to provide such discussion and explanation of the problems as will make their study beneficial. The editor will welcome discussion of the solutions published.

PROBLEM 1
Intermediate Examination, October 1954
Accounting I, Question 2 (15 marks)

(9 marks) (a) How do you compute the annual charge for depreciation when it is to be calculated by:
- (i) the straight line method,
- (ii) the diminishing balance method, and
- (iii) the units of production method?

(6 marks) (b) Explain, when depreciation is computed on an individual asset basis and when it is computed on a group (or composite) basis, the differences in:
- (i) the computation and recording of the annual charge for depreciation, and
- (ii) the recording of the disposal of assets.

A SOLUTION

(a) Methods of Computing the Annual Charge for Depreciation

(i) *The straight line method*

Three figures are required for the calculation of the annual charge for depreciation: the original cost including cost of installation, if any, of the fixed asset; the estimated number of years of its service life; and its estimated salvage value at the end of its service life. The annual depreciation charge is then calculated at an amount which will spread the cost less estimated salvage value in equal amounts over the estimated service life.

(ii) *The diminishing balance method*

The same data are required as for the straight line method. The annual depreciation charge is again determined with the objective of reducing the initial cost to scrap value by the end of the estimated service life; but the depreciation charge is different each year with the annual amounts calculated by taking a fixed percentage of the figure for cost less depreciation recorded to date.

(iii) *The units of production method*

The three figures required for calculation of the annual charge for depreciation by this method are: the initial cost including cost of installation, if any; the estimated number of units the asset is expected to produce during its service life; and the estimated salvage value of the asset at the end of its useful life. The depreciation applicable to each unit of production is then calculated by dividing the number of units expected to be produced into the initial cost less salvage value. The annual charge for depreciation is calculated by applying this predetermined unit depreciation charge to the number of units actually produced during the year in question.

(b) The individual asset versus the group basis of recording depreciation

(i) *The method of recording depreciation*

When the individual asset basis is used, each item of fixed assets is considered individually in determining the appropriate rate of depreciation and the annual charge is calculated for each asset by applying this rate. When the group basis is used, the fixed assets are classified by groups on the basis of their average useful life and the appropriate rate of depreciation applied to the group as a whole. There is no difference in the entries which record the depreciation.

(ii) *The recording of the disposal of assets*

When the individual asset basis is used, the cost of each separate fixed asset disposed of, and the accumulated depreciation recorded to date against it, are eliminated from the accounting records, with the resulting profit or loss on disposal reflected in the income account for the year or in retained earnings. When the group basis is used, the cost of a fixed asset disposed of is credited to the asset account and charged to accumulated depreciation. Any salvage value is credited to accumulated depreciation.

PROBLEM 2

Final Examination, October 1954

Accounting I, Question 3 (20 marks)

Mr. L, owner of the L Press, has recently heard of the many advantages of a good cost system. He has asked you to set up a system suitable for his business.

You determine that Mr. L has been in business for 25 years and has always taken a keen interest in his accounting department. He would like to have the cost system controlled by the general ledger.

The L Press is a medium sized business engaged in printing books, periodicals, calendars, advertising matter, Christmas cards, etc., some of which are put into finished stock and some of which are made to the customer's order.

Required:

Describe the system you would recommend and how it will operate to meet Mr. L's requirements.

A SOLUTION

The L Press should install a job cost system which will serve to classify its costs on the basis of customers' orders and each specific type of merchandise produced for stock.

The basis of such a system is the "job order cost card". Each card will be prenumbered and will have entered on it the details of the customer's order or production order to which it relates. Provision will also be made for the approval of these details by the foreman or management. The job order cost card is the medium for bringing together the various costs applicable to each job. The costs are entered on the card from the monthly summary of stores issues, the monthly or weekly wage distribution, the monthly summary of application of factory service, and from actual invoices (for direct outside purchases). The card should also show the number of units produced, spoilages, shortages, and shipments.

By this system, the work in process inventory will be the total costs accumulated to date on the job order cost cards for jobs which are not yet completed. When a job is completed the relevant card will be added and approved. The finished goods will be counted and checked with the production order and transferred to finished goods inventory. The accounting record for finished goods will be on the perpetual inventory system, with the completed job order cost cards providing the data of finished goods produced.

The completed job cost card for a customer's order will also be the basis for invoicing the customer, and for transferring the cost from Finished goods account to Cost of goods sold.

A perpetual inventory system should be maintained for raw materials. All issues of material must be recorded on an approved form with a note of the job order number. The quantities shown on these forms will be assembled on a monthly summary of stores issues and a dollar amount assigned to them in accordance with the company's method of inventory valuation. The details are posted from the monthly summary to the various job order cards.

Employees' time will be recorded on time clock cards from which it should be possible to account for total hours worked. The information on the time cards will be recorded on a daily time sheet on which the various jobs are charged with the labour spent on them, and approved. In turn, a labour summary or wage distribution is prepared at weekly or monthly intervals, charging the labour cost to the various jobs on the basis of the daily time sheets. The details of total hours and wages are posted from the labour summary to the job order cards.

The factory service costs will be recorded in expense accounts. Each month, an application summary will be prepared bringing together the various factory service expenses for the period and allocating them on some appropriate basis to the different jobs. The factory service expense element recorded on the job order cards is posted from this monthly summary.

The general ledger will include accounts which show cost of goods sold, cost of finished goods on hand, and costs of work in process broken down as to material, labour, and factory service.

PROBLEM 3

Final Examination, October 1954

Accounting I, Question 4 (15 marks)

The E Co. Ltd. has, at 1 Jan 1950, outstanding capital stock of a par value of $100,000 and earned surplus of $20,000. The A Co. Ltd. purchased, on the open market, the following interest in the E Co. Ltd.:

Date of Purchase	Purchase Price	Per Cent of Common Shares Purchased
1 Jan 1950	$60,000	40
1 Jan 1951	22,000	15
1 Jan 1952	35,000	25

The following relate to the operations of the E Co. Ltd.:

Year ended 31 Dec	Profit (before dividend) for the year	Dividends paid 31 Dec
1950	$16,000	$10,000
1951	18,000	10,000
1952	20,000	15,000
1953	24,000	15,000

On 30 June 1953, the A Co. Ltd. sold 10% of its holdings of E Co. Ltd. stock for $15,000. Profits are to be assumed to have been earned evenly over the year and the investment sold is to be computed on a first-in, first-out basis.

Required:

(8 marks) (a) Reconstruct the investment account as it would appear on the books of A Co. Ltd. from 1 Jan 1950 to 31 Dec 1953:

(i) where the investment in subsidiary account was carried on a cost basis, and

(ii) where the investment in subsidiary account was carried on an equity or book basis.

(7 marks) (b) Compute the minority interest and goodwill as it would appear on the consolidated balance sheet of the A Co. Ltd. at 31 Dec 1953.

A SOLUTION

(a)

BOOKS OF A CO. LTD.

(i) Investment in subsidiary account is carried on a cost basis

INVESTMENT IN E CO. LTD

Date	Explanation	Folio	Dr.	Cr.	Dr./Cr.	Balance
1950						
Jan 1	Purchase of 40%		60,000		Dr.	60,000
1951						
Jan 1	Purchase of 15%		22,000		Dr.	82,000
1952						
Jan 1	Purchase of 25%		35,000		Dr.	117,000
1953						
Jun 30	Sale of 8%			12,000	Dr.	105,000

(ii) Investment in subsidiary account is carried on an equity or book basis

INVESTMENT IN E CO. LTD.

Date	Explanation	Folio	Dr.	Cr.	Dr./Cr.	Balance
1950						
Jan 1	Purchase of 40%		60,000		Dr.	60,000
1951						
Jan 1	Purchase of 15%		22,000		Dr.	82,000
Dec 31	Earnings for 1951 (55%)		9,900		Dr.	91,900
Dec 31	Dividend received			5,500	Dr.	86,400
1952						
Jan 1	Purchase of 25%		35,000		Dr.	121,400
Dec 31	Earnings for 1952 (80%)		16,000		Dr.	137,400
Dec 31	Dividend received.			12,000	Dr.	125,400
1953						
Jun 30	Earnings for six months (80% of 12,000)		9,600		Dr.	135,000
Jun 30	Sale of 8% (see note)			14,000	Dr.	121,000
Dec 31	Earnings for six months (72% of 12,000)		8,640		Dr.	129,640
Dec 31	Dividend received			10,800	Dr.	118,840

Note: Original cost of shares sold: 8/40 of $60,000		$12,000
Earnings of subsidiary 1 Jan 1951 — 30 Jun 1953	$50,000	
Dividends of subsidiary 1 Jan 1951—30 Jun 1953	25,000	
8% of	25,000	2,000
Book value of shares sold 30 Jun 1953		$14,000

(b)

CALCULATION OF MINORITY INTEREST IN E CO. LTD. 31 DEC 1953

Capital and surplus of E Co. Ltd. 31 Dec 1953:		
Share capital	$100,000	
Earned surplus	48,000	
	$148,000	
Minority interest — 28% of $148,000		$ 41,440

Calculation of Goodwill as at 31 Dec 1953:

Cost of shares purchased 1 Jan 1950 and still retained 31 Dec 1953: \$60,000 — 8/40 of \$60,000 =	\$ 48,000	
Equity acquired in capital and surplus of E Co. Ltd. at as at date control acquired (1 Jan 1951): 32% of (\$100,000 + \$26,000) =	40,320	
		\$ 7,680
Cost of shares purchased 1 Jan 1951	22,000	
Equity acquired in capital and surplus of E Co. Ltd.: 15%of (\$100,000 + \$26,000) =	18,900	
		3,100
Cost of shares purchased 1 Jan 1952	35,000	
Equity acquired in capital and surplus of E Co. Ltd.: 25% of (\$100,000 + \$34,000) =	33,500	
		1,500
Goodwill on consolidation 31 Dec 1953		\$ 12,280

Editor's note: As A Co. Ltd. does not own more than 50% of the shares of E Co. Ltd. until 1 Jan 1951, it would probably not "take up" the profits and dividends of E Co. Ltd. *as a subsidiary* before that date. If it did take up profits and dividends from 1 Jan 1950, however, the balance in "Investment in E Co. Ltd." account in the general ledger would be \$120,760 as of 31 Dec 1953, when carried on an equity basis; and goodwill of consolidation as of the same date would be \$14,200. The minority interest would not be affected.

(*Correspondence with the editor is cordially invited.*)

A CORRECTION

In the article "Some Questions About Working Capital" by Howard I. Ross, published in the April issue, we regret a typographical error which appeared in the second to last paragraph under the heading "The Varying Need for Cash". The sentence should have read "In other words, age of the plant is of great effect in interpreting the working capital position."

The Tax Review

By Melville Pierce, B.A., LL.B.

RECENT TAX CASES

Stock Exchange Bldg. Corp. v. Minister of National Revenue

(Supreme Court of Canada, Rand, Estey, Locke, Cartwright and Abbott, JJ., January 25, 1955)

Interest on Borrowed Capital — Debentures issued at 90 — Whether interest claimable on more than 90 — Interest on overdue interest — Not borrowed capital — IWTA (1948) s. 5(1)(b)

Appellant corporation sold mortgage debenture bonds in the face amount of $550,000 to finance the construction of an office building in Vancouver, the trust deed providing for interest thereon at 6% per annum and interest on overdue interest at the same rate. The bonds were issued at a discount of $1 per $100 bond and the underwriter of the issue received a brokerage fee of $9 per $100 bond, appellant netting only $90 per $100 bond. By December 1, 1932 interest was in arrears and remained so ever since. In its 1946, 1947 and 1948 taxation years appellant claimed deductions of the compound interest due in such years (though not paid therein) in respect of the arrears of interest, but these deductions were disallowed by the Minister. For each of the said years appellant also claimed a deduction for interest payable in such years on the face amount of the bonds, *viz* $100 per bond, but the Minister would only allow a deduction for interest on the amount actually received by appellant on the issue of the bonds, *viz* $90 per bond. Appellant appealed to the ITAB, which dismissed the appeal on the first point but on the second point held that appellant was entitled to deduct interest on $99 per bond. On appeal to the Exchequer Court, the judgment of the ITAB on the second point was reversed. On appeal to the Supreme Court of Canada:

Held, the Minister was right on both points and the appeal must be rejected. (1) The interest in default upon which the compound interest was payable was not "borrowed capital used in the business to earn the income" within the meaning of that phrase in IWTA s. 5(1)(b) and was therefore not an allowable deduction. To justify the allowance of the claimed deduction the relationship of borrower and lender must be created at the outset between the taxpayer and the person to whom the interest is payable. Here there was no such borrowing of the interest in default; it was merely a debt which became payable by reason of the inability of the borrower to pay the interest as it fell due. It was not in any sense capital used in the business to

earn the income within the meaning of the paragraph. (2) The borrowed capital referred to in s. 5(1)(b) is the amount of money borrowed and not the extent of the obligation incurred in order to borrow it. Here appellant obtained only 90% of the face amount of the debentures and it was that amount alone which was used in the business and upon which interest may be allowed as a proper deduction from income. (While it was not clear from the evidence whether the underwriter purchased the bonds outright from appellant at 90% of their face amount or merely undertook to purchase and did purchase such of the debentures as were not purchased by the public at that rate, it makes no difference for the decision of the point in issue.)

Appeal dismissed

INCOME TAX APPEAL BOARD CASES

Fabio Monet, Esq., Q.C. (Chairman), Cecil L. Snyder, Esq., Q.C. (Assistant Chairman), W. S. Fisher, Esq., Q.C. and R. S. W. Fordham, Esq., Q.C.

200 v. M.N.R.

Interest on Borrowed Money — Company borrowing money with interest payable at end of 20 years — Intention that interest be paid annually — Intention determines legal obligation — ITA s. 11(1)(c)

Appellant, a cooperative company, pursuant to a by-law confirmed by its members, borrowed from the members each year an amount equal to the patronage dividends due the members for use in the company's operations. The by-law provided that "such loans shall be repaid by the cooperative within 20 years together with interest thereon at the rate of 4% per annum, or at a rate not exceeding 4% per annum". The company paid interest on the loans in two succeeding taxable years (both ending in 1953), and the Minister having objected that there was no legal obligation to pay interest annually the by-law was then amended to require the interest to be paid annually. In assessing the company for the two financial years the Minister disallowed a deduction claimed by the company for the interest actually paid on the members' loans in that year, contending (1) that there was no legal obligation to pay interest annually under the terms of the by-law and (2) that since interest was declared to be payable "at 4% per annum or at a rate not exceeding 4% per annum" the company was not obliged to pay any interest whatever. ITA 1952 s. 11(1)(c) permits the deduction of "an amount paid in the year or payable in respect of the year . . . . pursuant to a legal obligation to pay interest on (i) borrowed money used for the purpose of earning income from a business . . . or a reasonable amount in respect thereof, whichever is the lesser". At the hearing of this appeal the Board was satisfied from the evidence that notwithstanding the phraseology of the by-law it had been the intention of both directors of the company and the members that interest would be paid at 4% annually.

Held (Mr. Fisher and Mr. Monet), it must be found that it was the intention

of appellant to pay interest annually at 4% on the loans obtained from its members and that appellant was under a legal obligation to pay interest to its members at the rate of 4% per annum on the loans, and that this was a reasonable rate of interest. If the Minister's contentions were correct that the rate of interest was not fixed it may well be that interest was legally demandable by the members at 5% under the *Interest Act*, R.S.C. 1952, c. 156, s. 3.

Jan 21/55 *Allowed*

225 v. M.N.R.

Income or Capital Gain — Purchases and sales of property — Intention of taxpayer — Whether to make a gain on sale or to invest

Appellant carried on a grocery business in a city since 1913, and for several years prior to 1948 purchased and sold real estate on many occasions, and held a large number of dwellings leased for short terms and stores and offices leased for terms of 5 to 25 years. In 1944 he purchased some lots with the intention of erecting 3-storey apartment houses on them which he would rent, but shortage of materials obliged him to postpone this project. In 1947 a new city by-law prevented the erection of 3-storey houses and as he thought it not profitable to build 2-storey houses there he sold the property. In July 1945 he purchased a property comprising 3 stores and 6 apartments close to his grocery store, his intention being to reconstitute 2 of the stores into a self-service grocery store which he would then operate. However, rental control regulations made it impossible for him to evict the present tenants, and other events happened to make him change his plans and to sell the building, which he did. From all sales of property made by him in 1948 appellant realized gains of nearly $68,000, which he contended to be a capital increment.

Held (Mr. Monet), the appellant's conduct, examined in the light of all the circumstances of the said purchases and the said sales, shows that he purchased the property and the lots in question for the purpose of making a capital investment and the profits he realized on the resale are not from a profit-making venture but should be considered to be capital gains.

Dec 31/54 *Allowed*

Smith v. M.N.R.

Income or Capital Gain — Real estate dealer buying and selling mortgages — Whether part of regular business

Smith, a realtor and insurance agent residing in St. Thomas, Ont., sold properties for customers but also bought and sold properties on his own account from time to time. Between 1946 and 1951 he executed more than 20 such transactions on his own account. He also made money through purchasing mortgages at a discount and later selling them at a profit. Over a period of 8 years he bought and sold some ten mortgages, holding each of them for periods varying from 6 months to two years before selling them. He was assessed to income tax for 1949, 1950, and 1952 on the gain made by him in each of those years on these mortgage discounting transactions, and he appealed, contending that the gains so made were capital in nature and not taxable.

Held (Mr. Fordham), what Smith did in respect of these mortgages was so close-

ly related to his regular business as a realtor as to form part of it, and the profits in question were therefore chargeable as income.

Ont, Jan 31/55 *Dismissed*

236 v. M.N.R.

Income or Capital Gain — Farmer buying farm in knowledge of increasing value — Whether gain on sale income or capital gain —

Appellant, an immigrant to Canada, purchased two farms of 100 acres each in the vicinity of a large eastern city in 1940, which he farmed thereafter until 1950, in later years growing hay and alfalfa. In 1950 he purchased for $13,000 a farm of some 53 additional acres adjoining his own farm and a few months later bought for $40,000 an additional farm of 40 acres adjoining his own farm. The character of the land was changing rapidly, and in December 1950 appellant was offered and accepted $120,000 for the 93 acres which he had bought earlier that year.

Held (Mr. Fordham), there was no reason to reject appellant's evidence that he bought the land in question as an investment even though it must also be found that he shrewdly saw the opportunity for making a gain owing to the changing character of the neighbourhood. It could not be found that he was making a business of buying and selling land, and the profit made on the realization of an enhanced value of property can only be taxed if that realization is an item in a trade: *Collins* v. *Firth-Brearley Stainless Steel Syndicate* (1925) 9 T.C. 520, per Rowlatt J. at p. 564. In this case, where the decision turns on the facts, any doubt should be resolved in favour of the taxpayer because the incidence of income taxation should not be strained in order to bring a person within the ambit of a taxing statute.

Feb 10/55 *Allowed*

Editorial Note: One has the impression in reading many of these latter-day cases involving the classical issue: capital gain or income profit, that the point of view is changing, and that more attention than formerly is being given to the principles governing the interpretation of statutes and to the ancient and sound rule that the subject shall not be taxed unless Parliament has said that he shall.

238. v. M.N.R.

Income or Capital Gain — Isolated trading venture under IWTA — Profit not taxable

Appellant, a lawyer retired from practice, entered into three deals in 1946, from each of which he made a profit, upon which he was assessed to income tax under the Income War Tax Act. (1) Having obtained a lease to explore designated land for natural gas he sold the lease at a profit, before doing any exploratory work, to a company, taking shares in the company in exchange. (2) In association with some others he purchased some metal pipe from surplus war supplies, in the knowledge that a certain municipality required pipe to instal a pipe-line for the transmission of gas. The pipe was sold at a profit to certain companies constructing the pipeline from the gas well to the municipality. (3) As solicitor for a client he obtained a salt lease on certain land, eventually obtaining a 15% interest thereon. Exploration work resulted in the discovery of salt, and the lease was eventually sold at a profit to a company.

Held (Mr. Fisher), the profit made by appellant on each of these transactions was a capital receipt arising out of an isolated transaction which did not form part of appellant's ordinary business.

Feb 10/55 *Allowed*

Editorial Note: Although the learned judge did not find it necessary to say so, it is fairly evident that this decision turns on the definition of income in the IWTA, which does not bring the profit made on an isolated commercial venture within the ambit of the income tax. Under the present Act the profit made on an isolated venture is taxable if the isolated venture is commercial in nature. Whether any of the three isolated transactions of this appellant would be found by a tribunal of fact to be commercial in character is a moot point which it was not necessary to decide in this case.

Robinson Industries Ltd. v. M.N.R.

Companies — Undistributed Income on hand — ITA 1948 s. 95A — Amount of capital set aside as distributable surplus — Distribution of to shareholders a dividend — Amount deductible from undistributed income on hand

Appellant company, incorporated by letters patent under the Dominion Companies Act, carried on business in Ontario from 1928, earning some $516,000 during the years 1928 to 1932 inclusive from which dividends of some $351,000 were paid, leaving the company with undistributed earnings of some $165,000 at the end of 1932. In December 1933, supplementary letters patent were issued confirming a by-law of the company declaring the company's capital to be $830,484.00 and authorizing the setting aside as distributable surplus of an additional $200,000 which the company had on hand. The total of these two sums appeared to be the consideration received by the company from the issue of 54,984 common shares without nominal or par value. Between March 9, 1934 and March 15, 1940 the company distributed to its shareholders $179,000 of the said distributable surplus in various amounts, each distribution being accompanied by a letter from the company stating that the sum paid was a distribution of distributable surplus constituted by the supplementary letters patent, and that it was non-taxable. In addition to these distributions of distributable surplus the company also paid ordinary dividends to its shareholders during the period mentioned. In June 1953 appellant filed an election under ITA 1948 s. 95A showing undistributed income on hand of $104,000 and a tax of 15% payable thereon. The Minister contended that the sum of $179,000 distributed to shareholders as above described between 1934 and 1940 (which distributions, for some reason, were not charged to tax in the hands of the shareholders) must be regarded as part of the company's undistributed income on hand for the purposes of the election under ITA 1948 s. 95A, and that such distributions of distributable surplus were not distributions of dividends within the meaning of ITA s. 82(1)(a)(vii). Appellant appealed, contending that the distributions of distributable surplus were dividends and properly deductible in computing the company's undistributed income on hand for purposes of s. 95A.

Held (Mr. Fordham), any distribution of a company's assets to its shareholders when the company is not in liquidation, unless made as an authorized reduction of capital, is a dividend: *Hill* v. *Permanent Trustee Co. of New South Wales* 1930 A.C. 720 followed. The amount set aside as distributable surplus by the company was not part of its capital: see s. 12(7) of the *Companies Act*, R.S.C. 1952, c. 53.

Ont, Dec 20/54 *Allowed*

226 v. M.N.R.

Companies — Holding company in receipt of exempt income — Obligatory expenses — Whether apportionable for deduction between exempt and non-exempt income — ITA (1950-1) s. 12(1)(c)

Appellant was a large holding corporation, holding the shares, debentures and other securities of 17 wholly-owned subsidiaries engaged in the alcoholic beverage business in Canada, the U.S.A., and overseas and controlled 5 other corporations in Canada; it did not engage in trading. In the taxation years 1950 and 1951 it claimed deductions of $164,000 and $179,000 respectively in respect of general expense, printing and stationery, audit fees, stock transfer expense, provincial capital tax, proxy expense, listing fees for common stock, directors' fees, interest on bank loan, and legal fees, which were rendered necessary because of the requirements of the Companies Act regardless of whether or not any tax-exempt income was received by appellant. The Minister would, however, allow a deduction only of a portion of the expenses in question, *viz* an amount proportionate to the taxable income of the company, which was about 4% of its total income for the years in question.

Held (Mr. Fordham), the Minister's assessment was correct having regard to s. 12(1)(c) prohibiting the deduction of an outlay or expense to the extent that it may reasonably be regarded as having been made or incurred for the purpose of gaining or producing exempt income or in connection with property the income from which would be exempt. See *Premier Trust Co.* v. *MNR,* 54 D.T.C. 364; 11 T.A.B.C. 124 (Mr. Monet).

Dec 30/54 *Dismissed*

Canadian Import Co. v. M.N.R.

Pension Plans — Past Service Contribution — Right to deduction by successor company — ITA (1951) s. 69

By a contract made in December 1950 appellant company acquired the assets and assumed the obligations of another company, including the latter's rights and obligations under an approved pension plan which it had instituted for its employees some years before. Appellant continued to employ the vendor company's employees and arranged for the continuance of the pension plan, and for the 1951 taxation year claimed a deduction of $14,200 in respect of special payments made by the vendor company to the pension plan in the years 1943 to 1949, the right to the deduction being asserted under ITA 1948 s. 69, which provides:

69. Where a taxpayer is an employer and has made a special payment or payments on account of an employee's superannuation or pension fund plan in respect of the past services of employees pursuant to a recommendation by a qualified actuary . . . . there may be deducted in computing the income for the taxation year the lesser of
   (a) 1/10 of the whole amount so recommended to be paid, or
   (b) the amount by which the aggregate of the amounts so paid during a period not exceeding 10 years ending with the end of the taxation year exceeds the aggregate of the amounts that were deductible under this section in respect thereof in computing the income of the taxpayer for the previous years.

Held (Mr. Monet), dismissing the appeal, appellant did not meet the requirements of s. 69 that the payment or payments be made by the taxpayer claiming the deduction.

Que, Dec 14/54 *Dismissed*

234 v. M.N.R.

Trusts & Estates — Capital Cost Allowances — Life tenant — Right to encroach on corpus — Whether entitled to capital cost allowances — ITA (1952) s. 58(6A)

A testator by his will left the usufruct of his estate to his wife, remainder to his daughter, with a right to his wife to encroach on the capital of the estate to offset any insufficiency or loss of income, to defray the costs of illness or meet any other circumstances which would force her to lower her ordinary standard of living, under the control of executors. Testator died in 1947. In 1952 the wife's income from the estate was $4,675, and in that year she encroached on the capital for the first time. In reporting her income from the estate for 1952 she claimed a deduction of $3000 as capital cost allowance on the immovable property included in the estate. She rested her claim to capital cost allowance on ITA s. 58(6A), which provides that "a beneficiary . . . who is entitled, either contingently or absolutely, to the property of the . . . estate or some part thereof at some future time, may deduct" capital cost allowances as allowed by the executors of the estate. The Minister disallowed the claim of appellant, on the ground that she was not entitled either contingently or absolutely to the property of the estate at some future time within the meaning of s. 58(6A). Appellant's contention was that her right to encroach on the capital constituted a future contingent right to the property of the estate but, even if it did not, that her actual exercise of the right of encroachment in 1952 constituted an appropriation of the property encroached on and brought her within the words of s. 58(6A). *Held* (Mr. Monet), appellant was only life tenant (usufructuary) of the estate and her right to encroach on the corpus did not give her any title to the corpus so as to make her contingently or absolutely entitled thereto at some future time within the meaning of s. 58(6A); and her appeal must be rejected.

Que, Feb 4/55 *Dismissed*

Parton v. M.N.R.

Gift Tax — Partnership Agreement — One partner contributing cash, the other skill — Whether cash contribution a gift — Whether a transfer of property — IWTA s. 88(7)

Appellant and his father entered into articles of partnership to conduct a hardware business, the father contributing $36,000 in cash and the son $6,000. The articles set out that the partners should have an equal interest in the partnership, that the profits should be divided equally, that the son should devote his whole time to the management of the business, the father such of his time as he thought fit, and that the son could not withdraw from the partnership during the father's lifetime without the father's consent. The business was carried on in accordance with the terms of the articles under the active management of the son. The Minister contended that in contributing $36,000 to the partnership the father had made a gift of some $15,000 to the son, and that this amount was subject to gift tax. *Held* (Mr. Snyder), the father and son had entered into a valid partnership, under which the father contributed a large sum of cash and the son his skill and managerial ability, and the excessive contribution of the father in cash was therefore not a gift. It is for the parties to

such an agreement to estimate the value of their respective contributions. While IWTA s. 88(7) empowers the Minister to determine that any transfer of property on the basis of a *quid pro quo* is a gift if he is of opinion that the value of the properties passing are disproportionate to one another, there was not here any transfer of property from the father to the son.

Alta, Jan 21/55 *Allowed*

Jones v. M.N.R.

Fiscal Period — Change in — Admission of new member to partnership — Automatic change in fiscal year — Whether Minister can confer right to lower tax rate by concurring in change retrospectively — ITA 1948, s. 34A

Jones carried on a butcher business in partnership with another man, the fiscal year of the firm ending on September 10 of each year. On November 30, 1952 a new member was introduced to the partnership, and the old firm wound up as of that date. In his income tax return for 1952, filed in April 1953, Jones included his income from the partnership for the 12 month fiscal period ending September 10, 1952 and for the following period ending with the dissolution of the partnership on November 30, 1952, and subsequently applied to the Minister for his retrospective concurrence in a change of the firm's fiscal year in order that Jones might avail himself of the option provided by s. 34A to pay a lower rate of tax on his business income for 1952. The Minister, however, assessed Jones without applying the provisions of s. 34A, which he contended was inapplicable. Appellant appealed, and at the outset moved that the Board refer the matter back to the Minister in order to enable him to advise the appellant either that he did or did not concur in the change which appellant had made in his fiscal year in 1952.

Section 34A provides for the computation of tax at a lower rate, where, *inter alia*,

> . . . by reason of a change made with the concurrence of the Minister in the fiscal year of a .... partnership there would .... be included ....
>
> (b) income from the partnership for each of two or more fiscal periods,

Held (Messrs. Fisher and Snyder), the Board could take no cognizance of the motion made by appellant as it was not supported by sworn evidence, but in any event it was admitted by appellant that the Minister had not concurred in a change in his fiscal period for 1952, and therefore a condition prerequisite to the invocation of s. 34A had not been satisfied.

B.C., Feb 2/55 *Dismissed*

Editorial Note: On the procedural point, namely the motion that the Board remit the matter to the Minister to allow him to give or refuse his concurrence to a change in appellant's fiscal year, it would seem quite clear that the Board has no jurisdiction to grant such a motion. The powers of the Board are set out in explicit language in s. 92 of the Act, and unlike a superior court of common law the ITAB has no inherent jurisdiction.

On the second point, that the Minister has the power under s. 34A to give retrospective concurrence to a change in a fiscal year, a reading of the enactment seems clearly to indicate that this cannot be so. That section (which is now ITA 1952 s. 37(1)), provides that where a specific result follows from a specific cause the taxpayer may choose between courses. It is not the fact that income for two fiscal periods falls within one calendar year that confers the choice; the choice is given only if the described situation arises *because* a change was made in a fiscal year with the concurrence of the Minister, and that cause can hardly succeed its own consequence.

Practitioners Forum

By Geoffrey H. Ward, C.A.

STAFF RECRUITMENT AND TRAINING

STAFF recruitment has received a great deal of attention from the accounting profession, particularly in the last few years. The low birth rate of the 1930's coupled with post-war expansion has resulted in a shortage of qualified young men and heavy competition for their services in the 1950's.

Recruitment and Morale

In *The Journal of Accountancy* for December 1953, Charles E. Johnson, Ph.D., CPA, writes on this subject. His article is entitled "Three Necessary Elements in Recruitment of Staff and in Maintaining Efficiency and Morale". The following comments are taken from his article.

The general problem of proper recruitment for the profession, says Dr. Johnson, has been brought to a head by the current shortage of personnel. Past experience has shown that professional fields tend to follow an S-shaped growth curve. That is, the growth starts off slowly, rises at an increasingly rapid rate until the rate of increase is fairly constant, then the growth rate reaches a saturation point followed by a levelling-off period. At present our profession appears to be at the stage where it is increasing at a fairly constant growth rate, with the saturation point and levelling-off period a generation, say 20 years, away. This indicates that the demand for accountants will continue for many years.

To examine this problem we must look at the supply prospects. Because of the low birth rate during the 1930's and defence mobilization today, we can expect that the next 10 years will produce a smaller number of university graduates available for the professions than was available before the war. So the present prospects indicate continued pressures on the employment side of the professional market.

Dr. Johnson says, "The long-run outlook is for a continued increase in the demand for public accounting services and thus for additional professional manpower. The need for highly trained accountants is peculiarly a consequence of large-scale business operations and of government regulation and taxation of business. No one seriously expects that these trends are going to be materially reversed in the foreseeable future. One final element in the long-range-demand picture is the need to replace those retiring from the profession. What does all this boil down to? In the short-run a strong demand in the face of a declining number of well-qualified entrants into professional accounting. In the long-run the prospect of a growing profession faced with the serious problem of recruiting talent into its ranks."

The problem is threefold. The first aspect, to attract qualified students to embark initially upon a career of accounting, is a joint responsibility shared by practising accountants, professional societies, and university staffs. The second

aspect, to attract good students upon graduation into the public accounting profession, is essentially the responsibility of the profession who are in a position to do a partisan selling job. The third aspect, to keep promising young employees after graduation, is the responsibility of the individual practising firms. Let us give further consideration to this phase.

How can we make public accounting attractive during the formative years? As we are all aware, a great deal of attention has to be paid to salaries. Beginning salaries must be relatively competitive. However, the smarter of the promising graduates will ask themselves "How much can I learn and develop in this position in the next five years?" To students with this sound view, the public accounting profession has a good position to sell, according to Dr. Johnson. "No one right out of college is worth much to his employer. A person with five years of good solid experience who has had an opportunity to exercise initiative and responsibility is, however, in a good position no matter in what particular blind spot he may find himself at the moment. If he is not in a position to advance his present status, and in the majority of cases he will be, he is prepared and qualified to move out into other positions of responsibility and commensurate compensation."

Dr. Johnson also has a good point on security. He states, "Any employee worth his salt knows that the man with most security is the man who can walk out the door at any time and find a number of attractive offers waiting. And that's exactly the kind of man firms should not want to lose. The employee who is easy to keep and to satisfy is likely to be the kind of person who is most expendable. In most top-notch accounting firms you will find someone doing a lot of planning and thinking about how to hold on to their best men and how to make their positions attractive to them."

Now let's look at this from the standpoint of the junior accountant. Just what does he want? Well, he wants to feel important, to feel that he is doing something worthwhile and significant. This will require a conscious effort on the part of more senior personnel to give him as many opportunities as possible to undertake responsible assignments. He should be treated as a fellow professional accountant not just as an employee.

A young professional man wants to feel that he is learning and progressing in his profession. To satisfy this need careful consideration should be given to the practical training made available to each staff member. "One of the best opportunities to develop in the early stages of experience is afforded by working with senior accountants who take a conscious interest in explaining what is going on, and who take the trouble and effort to discuss the interesting and troublesome problems that arise in an engagement and the basis on which they are resolved. Shifting staff men among assignments is another means of broadening the scope of their experience. A conscious effort to discover a staff member's preferences and to switch engagements whenever it can be accomplished without serious inconveniences will bring swift benefits in staff morale." Try to see that each member of the staff gets his share of the desirable and undesirable assignments.

An important requirement of a qualified accountant is the ability to write well. The author suggests that it is practice that is required. Therefore whenever practicable the promising young

junior should be given a chance to write the preliminary drafts of reports. And finally the staff man wants to be kept fully posted as to how he is doing. He expects to make mistakes and be told about them. Profiting from mistakes is an integral part of the learning process. He also expects to get credit and praise for good work when he deserves it. The effort and attention needed to give the student what he wants will be well worthwhile.

Training

As a natural follow-through on recruitment, we come next to staff training. We really have a single program, namely to attract suitable students and then give them adequate training. We all recognize the importance of staff training. However, in practice, especially in small firms, there are major problems hindering the carrying out of any formal program. The comments of other practitioners on this subject should prove interesting. Mr. L. Rosenblum, CPA conducts a regular feature "Current Trends in Accounting" in *The New York Certified Public Accountant.* In the August 1953 column he reported on two items in this area, which are reprinted below.

"STAFF TRAINING PROGRAMS

"In an article in the Pennsylvania Institute of Certified Public Accountants' Bulletin, *The Spokesman,* Robert L. Leonard discusses staff training in small public accounting offices.

"In large part, staff training is accomplished on the job, but formal training through lectures is necessary. Mr. Leonard suggests two-hour lectures on Saturdays during the last two or three months of the year — or at any other convenient time.

"The program might cover these subjects: (1) professional behaviour; (2) books and records and supporting documents; auditors' marks; (3) working papers, audit notes and indexing; (4) accounting principles and auditing procedures; (5) approach to problems; (6) tax accounting and tax return preparation; (7) systems; (8) cost accounting and renegotiation of government contracts; (9) government regulations generally; (10) AIA releases; (11) presentation of financial data; report writing; (12) case studies."

"HOW TO GET ALONG WITH PEOPLE

"Herbert D. Soper, CPA, of Arthur Andersen & Co., offers this message in a recent issue of *The Arthur Andersen Chronicle:*

> " 'Ability to get along with people — human relations — is a vehicle whereby the confidence of the firm as a whole is generated from within and transmitted to others. Too many personnel problems arise in business today as a result of "conflicts of personality". Many of these problems are avoidable. Too many of our own personnel and client relations problems stem from a lack of full understanding and cooperation between all individuals concerned. And many of them are avoidable. We must learn to adjust ourselves more readily to others, to respect their views and, without antagonism, present opposition and earn their respect. We must, if we are to realize our maximum potential as individuals and as a firm, work more affirmatively on our human relations.' "

An Actual Program

Now that we have read these comments perhaps we can stop and ask ourselves "What can we do?" A smaller firm may not be able to carry out all the ideal procedures. However we have been able to:

1. Conduct an aggressive search when looking for new staff;
2. Pay adequate salaries, "relatively competitive", that is;
3. Treat students as future chartered accountants;
4. Provide systematic supervision which will let the student know his mistakes. Semi-annually we make a formal but verbal report to him on his progress. This is done when considering the annual bonus and salary increase in June and again in December;
5. Encourage senior personnel to take a personal interest in developing their assistants;
6. Give junior staff some reports and letters to draft;
7. Issue staff manuals on firm policies and procedures and keep them current with regular amendments and additions;
8. Hold an annual two day staff meeting at which current problems are discussed;
9. While the number of audits does not permit frequent rotation of assignments we can shift staff from one audit team to another every two years.

Panel Members' Comments

This material was submitted to two members of my able panel of consultants. Mr. N. C. Hagan, C.A., of Moose Jaw, Saskatchewan commented as follows:

"To attract qualified students to embark initially upon a career of accounting, I would suggest that contact be made and maintained with high school principals and guidance counsellors. These are the individuals who are in close contact with high school students during those years when the student has not formed any definite decisions as to what career or profession he may embark upon. The high school principal and guidance counsellor are in a position to analyze to some degree a prospective student's aptitude for accountancy and to discuss initially this profession with him. Also booklets or pamphlets could be published by the Institute (provincial or Canadian) and made available to high school students. These booklets or pamphlets should be on an adult level and tone and not talk down to prospects. Their contents should be considered thoroughly before being published, as first impressions are often lasting ones.

"A prospective student should not be hired if he will not succeed or will not meet requirements as to personality, tact, and initiative. I realize that it is very difficult, in some cases, to determine an individual's aptitude for accountancy; however this problem should be considered very seriously at the time additions to the staff are made. I agree that a student should be treated as a fellow professional accountant, not just as an employee. However, if you are not careful in selecting your students an uncomfortable situation could develop because of the fact that students, improperly or carelessly selected, might take advantage of this relationship.

"Salary increases could include

special consideration for passing various exams and completing sections of the courses.

"I would recommend that staff meetings be held three or four times during the year, the length of each meeting contingent on the volume of current problems to be discussed."

Since hearing the discussion on staff meetings at the American Institute of Accountants' meeting in New York, I feel that a program of weekly one hour meetings, during 6 to 8 months of the year, are essential to get the full benefit from the staff manuals and to keep the training program moving ahead.

The other panel member observed:

"You say that there are major problems of carrying out a formal program. It seems to me that the smaller firms may soon have to set up some such plan if they are to attract their share of available qualified entrants into the profession. Although the salary scale may have a bearing on the selection of an employer by the employee there is no doubt that since the student's desire is to pass examinations a serious candidate will give considerable thought to the selection of an employer who will supply an adequate course of training.

"Some of the difficulties of arranging staff training programs might be overcome by dividing such a program into two sections. One would comprise the assimilating and explaining of the course of studies laid down by the provincial Institutes. This would be in the nature of a coaching class but carried out on a regular monthly basis from year to year rather than as a high pressure cramming session a few weeks before the examinations. The other would consider the problems and procedures which directly concern the practice in which the student is employed.

"It might be possible for two or more smaller firms within a given area to cooperate in the first category. I have always felt that the student who takes his course through a series of personal lectures has an advantage over another student who must through geographical location take his course by correspondence."

I would like to add an observation for any students who have read this far. As employers we are genuinely interested in seeing that you receive a thorough training and are well paid. To achieve both these ends we need your understanding and cooperation. The success of the training program requires hard work by the students. The employers' ability to pay good salaries depends on the fees earned by your services, which in turn depend on how well you do your work.

Do you agree that our recruitment problem will be largely answered by a good staff training program?

(The editor of this bi-monthly department cordially invites correspondence from readers.)

NEWS OF OUR MEMBERS

BRITISH COLUMBIA

William H. Power, C.A. announces the admission to partnership of Leslie Bestwick, C.A. Henceforth practice of the profession will be conducted under the firm name of Power & Bestwick, Chartered Accountants, Orion Bldg., Nanaimo.

Campbell, Imrie & Co., Chartered Accountants, 102 Radio Bldg., Kelowna, announce the change of firm name to Campbell, Imrie & Ashley, Chartered Accountants.

Campbell, Imrie & Co., Chartered Accountants, 12 Board of Trade Bldg., Penticton, announce the admission to partnership of M. E. Davis, C.A. and the retirement from the Penticton practice of G. D. Imrie, C.A. The practice will be conducted under the firm name of Campbell, Davis & Ashley, Chartered Accountants.

Campbell, Shankland & Yolland, Chartered Accountants, announce the removal of their offices to the Trail Credit Union Bldg., 1442 Bay Ave., Trail.

ONTARIO

Wallace & Somerville, Chartered Accountants, Edinburgh, and H. T. Jamieson, LeMay & Company, Chartered Accountants, Royal Bank Bldg., Toronto, announce that they will represent each other in Great Britain and Canada respectively.

H. H. Graham, C.A. and P. E. Molloy, C.A. announce the formation of a partnership for the practice of their profession at 424 Wellington St., London.

New Members: Since publication of the latest list of members the following persons have been admitted to membership in the Ontario Institute by affiliation: E. Rodriguez (Que '28), K. R. Arliss (Eng & Wales '51), F. C. Moncrieff (Man '54), A. J. Dorricott (Eng & Wales '33), L. M. Kershaw (Eng & Wales '54), J. V. Cortens (Man '48), D. E. Britchford (Inc Accts '53), R. L. MacKenzie (N.B. '53), J. M. Ballentine (Sask. '53), J. McLaren (Scot '26), R. A. Dingle (Man '43), R. J. Kelly (Ire '52), J. R. Trott (Que '54), H. S. Seare (Inc Accts '34, Eng & Wales 40)' W. W. Shepherd (Man. '41), G. D. Wood (Man '53), J. M. Burn (Man '50), R. D. Durward (N.B. '52), G. H. Cowperthwaite (Eng & Wales '49), P. Cowan (Eng & Wales '48), M. G. C. Howard (Eng & Wales '43), J. A. Conway (N.S. '47, Nfld '50), R. M. Price (Eng & Wales '52), R. T. M. McPhail (Scot '31), J. M. Mitchell (Alta. '36), N. H. Martin (Eng & Wales '38), W. A. Lyster (Que. '44), W. E. Shields (Man. '53), G. R. Graham (Que '48), G. R. McLellan (Alta '41), A. G. Martin (Que '54), W. Chapman (Eng & Wales '53), H. Copland (Inc Accts '50), H. F. Damkevala (Inc Accts '39), B. J. B. Galvin (Scot '53), J. S. Ogilvy (Scot '50), W. J. Macdonald (Man '15), G. L. Prefontaine (Que '54).

Lloyd L. LaRocque and Gordon R. MacGougan were admitted to membership in March 1955 by examination appeal.

QUEBEC

Arthur Alain, C.A., formerly assistant director general of the Provincial Sales Tax Department, announces that he is practising his profession at 2304 Hampton Ave., Montreal.

SASKATCHEWAN

Glen Campbell, C.A. is a member of the team "Campbells of Avonlea" which captured the MacDonald "Brier" trophy presented for the curling championship of Canada. Saskatchewan is proud of these champions because it is celebrating its golden jubilee in 1955 and this is the first time this trophy was won by a Saskatchewan team.

INSTITUTE NOTES

Ontario Institute

Plans have been made by the Ontario Institute to hold a 2-day conference for members of the Institute at Queen's University, Kingston, on Monday, June 18 and Tuesday, June 19, 1956. There will be technical sessions and the annual meeting will be held during the conference. Council has appointed Professor W. G. Leonard, F.C.A. of Kingston, as chairman of the Conference Committee.

The Ontario Institute is sponsoring a confidential survey of salaries and staff practices and 154 practising firms in Ontario are participating in it. A questionnaire which was approved by Council was sent in March to all the firms wishing to participate and was returned by April 15. It is expected that the information will be tabulated and sent to the firms participating some time in May.

The committee to consider changes in the Ontario Securities Act under the chairmanship of J. R. M. Wilson, F.C.A. completed its work and on March 1 presented its recommendations to Mr. Dana Porter, the Attorney General of Ontario. The letter to the Attorney General, (which was handed to him by the president of the Institute) was published in the April issue of *The Canadian Chartered Accountant.*

At the request of the Membership Committee, Council has considered the propriety of publishing cards in a public advertising medium announcing changes in the address, or changes in the names of the partners or employed personnel of practising firms. Rule 14 of the rules of professional conduct specifies what may be included in a business card and rule 15 states that changes in address or personnel may be announced by the circulation of a card. The Council decided that there was no objection to publishing a card where the address or partnership changed but that it was objectionable to publish a card in a public advertising medium where it was only to announce a change in the employed personnel of a firm.

The Canadian Industrial Traffic League (Ontario Division) have invited members of the profession to attend a dinner at 6:30 p.m., Thursday, May 19, at Muirheads Restaurant, 67 Richmond Street West, Toronto. Mr. F. P. Ryan, Eastman Kodak Company, Rochester, N.Y. will speak on "Traffic Expenses and the Accountant". Information regarding tickets may be obtained from Miss Stewart, Hargrave 2151.

Hamilton and District C.A. Association

The Hamilton and District Chartered Accountants Association in cooperation with five practising firms entertained at dinner a number of the principals and guidance counsellors of the secondary schools and guidance officials of the Boards of Education of the Niagara Peninsula, Brantford, Kitchener, and Hamilton on Tuesday, March 26, at the Hamilton Club. After dinner J. G. Brown, F.C.A. presented the Institute's film strip on "Careers in Canadian Accountancy", and H. C. Dixon, R. B. Taylor, and W. G. Thompson, Chartered Accountants, spoke of the opportunities for accountants in public practice, industry, and government service.

Ontario Students Association

The Students' Association held its regular monthly meeting in the C.A. Building, April 12. Mr. George Burne of the London & Lancashire Insurance Company spoke on "Business Interruption Insurance".

The editor welcomes information for this column. News of members and provincial Institutes' activities should be received by the 14th of the month to appear in the following issue of the journal.

RECENT BOOKS

Municipal and Governmental Accounting, 3rd ed., 1955, by Irving Tenner, M.B.A., Ph.D., C.P.A.; published by Prentice-Hall Inc., New York; pp. 569; price $8.65

This new volume incorporates the standards and principles of accounting for municipal governments as established and set out in publications of the National Committee on Governmental Accounting. In addition to revisions necessitated by changes advanced by that committee since the second edition was published in 1951, this latest work has been enlarged to include a chapter on institutional accounting, specifically for hospitals and colleges.

Since representatives of the Canadian Institute of Chartered Accountants are closely associated with the work of the National Committee on Governmental Accounting and the committee has the active support of the Municipal Finance Officers' Association, which has many Canadian members prominent in municipal government circles, its findings have had a wide acceptance in this country in the formulating of methods and procedures in this field of accounting. This influence is reflected in the Manual of Instructions published in 1942 by the Dominion Bureau of Statistics for the guidance of Canadian municipal accountants.

The greater part of Mr. Tenner's new book is taken up with fund accounting. Every local government must raise and spend its revenues in accordance with special regulations, restrictions, and limitations. This is done by establishing fund accounting. As every fund constitutes a separate fiscal and accounting entity, it is necessary to provide a separate group of accounts for each with the same classifications being followed in the budget and the financial returns.

The creation of separate funds should not be carried to an extreme, however. Those recommended for use and which are fully discussed in this book are (a) general, (b) special revenue, (c) working capital, (d) special assessment, (e) bond or debenture, (f) sinking fund, (g) trust and agency, (h) utility and other enterprise.

The remainder of the book deals with auditing of municipal accounts, with accounting terminology and a chapter briefly discussing cost accounting as applicable to municipalities. Finally, the last 130 pages is devoted to a series of questions and problems covering the whole book chapter by chapter.

For those who are interested in municipal accounting and auditing this should prove an excellent book of reference. Perhaps the more conscientious may find enjoyment in answering all of the questions set out at the end.

GEORGE H. GLENNIE, B.A., C.A.
Auditor of Metropolitan Toronto